Supreme Court, U. S.
FILED
JUL 28 1977
MICHAEL RODAK, JR., CLERK

No. 76-624

In the Supreme Court of the United States

OCTOBER TERM, 1977

FRANK LYON COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

WADE H. McCREE, Jr.,
Solicitor General,
M. CARR FERGUSON,
Assistant Attorney General,
STUART A. SMITH,
Assistant to the Solicitor General,
GARY R. ALLEN,
JOHN A. DUDECK, Jr.,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	3
A. The factual background	3
B. The terms of the sale-and-leaseback arrangement	11
1. Agreements between petitioner and Worthen	11
2. Construction financing agreements	16
3. Permanent financing agreements	17
C. The proceedings below	18
Summary of argument	21
Argument	26
I. The sale and leaseback arrangement in this case was a financing transaction under which petitioner did not have any significant ownership interest or investment in the building that would entitle it to tax deductions for mortgage interest and depreciation	26
A. The economic substance of sale and leasebacks is controlling for federal tax purposes	26
B. *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252, controls this case	32
C. The bargain terms of the lease renewal arrangement demonstrate that it is a financing transaction and not a true sale	44
D. Since petitioner is not the true owner of the building, it cannot claim deductions for mortgage interest or depreciation	52
1. Mortgage interest	53
2. Depreciation	56
E. The arrangement in this case was not the product of arms-length bargaining	58

Argument—Continued Page

II. The court of appeals correctly held that the federal tax consequences of a sale and leaseback present a question of law ---- 66

Conclusion ---- 71

CITATIONS

Cases:

ABKCO Industries, Inc. v. *Commissioner*, 482 F. 2d 150 ---- 68

American National Bank of Austin v. *United States*, 421 F. 2d 442, certiorari denied, 400 U.S. 819 ---- 26, 27

American Realty Trust v. *United States*, 498 F. 2d 1194 ---- 26, 43, 68, 69, 70

Benton v. *Commissioner*, 197 F. 2d 745 ---- 68

Breece Veneer & Panel Co. v. *Commissioner*, 232 F. 2d 319 ---- 43

Carlton v. *United States*, 385 F. 2d 238 ---- 68

City National Bank Building Co. v. *Helvering*, 98 F. 2d 216 ---- 34

Commissioner v. *Brown*, 380 U.S. 563 ---- 53

Commissioner v. *Court Holding Co.*, 324 U.S. 331 ---- 27

Commissioner v. *Danielson*, 378 F. 2d 771, certiorari denied, 389 U.S. 858 ---- 64

Commissioner v. *Duberstein*, 363 U.S. 278 ---- 27, 60

Commissioner v. *First Security Bank of Utah*, 405 U.S. 394 ---- 60, 61

Commissioner v. *H. F. Neighbors R. Co.*, 81 F. 2d 173 ---- 42

Commissioner v. *P. G. Lake, Inc.*, 356 U.S. 260 ---- 27

Commissioner v. *Sunnen*, 333 U.S. 591 ---- 27

Commissioner v. *Tower*, 327 U.S. 280 ---- 27

Copperhead Coal Co. v. *Commissioner*, 272 F. 2d 45 ---- 64

Corliss v. *Bowers*, 281 U.S. 376 ---- 26

Deputy v. *duPont*, 308 U.S. 488 ---- 54

F. & D. Rentals, Inc., v. *Commissioner*, 44 T.C. 335 ---- 64

F. and R. Lazarus & Co. v. *Commissioner*, 32 B.T.A. 633 ---- 33, 49

Franklin, Estate of v. *Commissioner*, 544 F. 2d 1045 ---- 26, 43, 68

Frenzel v. *Commissioner*, 1963 P-H Memo TC, par. 63,276 decided October 7, 1963 ---- 43, 49

Cases—Continued

Page

Frito-Lay, Inc. v. *United States*, 209 F. Supp. 886 ---- 43

Helvering v. *Clifford*, 309 U.S. 331 ---- 27

Helvering v. *F. & R. Lazarus & Co.*, 308 U.S. 252 ---- 21, 27, 32, 34, 55, 57, 66, 68

Holbrook v. *Commissioner*, 450 F. 2d 134 ---- 36

Iowa v. *McFarland*, 110 U.S. 471 ---- 28

Leeds and Lippincott Co. v. *United States*, 276 F. 2d 927, affirming an unreported decision of September 1, 959 (D. N.J.) ---- 43

Levinson v. *Commissioner*, 45 T.C. 380 ---- 64

M. DeMatteo Construction Co. v. *United States*, 433 F. 2d 1263 ---- 57

Midler Court Realty, Inc. v. *Commissioner*, 521 F. 2d 767 ---- 49

Mt. Mansfield Television, Inc. v. *United States*, 239 F. Supp. 539, affirmed, 342 F. 2d 99, certiorari denied, 382 U.S. 818 ---- 49

Nelson v. *Commissioner*, 281 F. 2d 1 ---- 55

Oesterreich v. *Commissioner*, 226 F. 2d 798 ---- 26, 43, 68

Old Colony R. Co. v. *Commissioner*, 284 U.S. 552 ---- 54

Starr's Estate v. *Commissioner*, 274 F. 2d 294 ---- 43, 49

Stirman v. *Cravens*, 33 Ark. 376 ---- 42

Union Planters National Bank of Memphis v. *United States*, 426 F. 2d 115, certiorari denied, 400 U.S. 827 ---- 26, 67–68

United States v. *Henderson*, 375 F. 2d 36 ---- 68

United States v. *Jackson Oldsmobile, Inc.*, 371 F. 2d 808 ---- 46

United States v. *Ludey*, 274 U.S. 295 ---- 56

United States v. *Winthrop*, 417 F. 2d 905 ---- 67

United States Fidelity & Guaranty Co. v. Commissioner, 40 B.T.A. 1010 ---- 55

William v. Kirby School Dist. No. 32, 207 Ark. 458, 181 S.W. 2d 488 ---- 42

Williamson v. *Berry*, 8 How. 495 ---- 28

World Publishing Co. v. *Commissioner*, 299, F. 2d 614 ---- 57

Statutes, rule and regulations:	Page
Internal Revenue Code of 1954 (26 U.S.C.):	
Section 162(a)	31
Section 162(a)(3)	38
Section 163	2, 31
Section 163(a)	54
Section 167	3, 31
Section 167(g)	58
12 U.S.C. 371d	5, 61
Fed. R. Civ. P. 52(a)	66, 67
12 C.F.R. 265.2f(7)	5
Treasury Regulations on Income Tax, Section 1.163-1(b) (26 C.F.R.)	56
Miscellaneous:	
American Institute of Real Estate Appraisers, *The Appraisal of Real Estate* (6th ed.)	40
C.R.C., *Standard Mathematical Tables, Interest Tables—Present Value of Annuity*	40
Cary, *Corporate Financing Through the Sale and Lease-back of Property: Business, Tax, and Policy Considerations*, 62 Harv. L. Rev. 1 (1948)	44, 58, 59, 64
FASB Statement of Financial Accounting Standards No. 13, Accounting for Leases (November 1976)	49-50, 52
Gant, *Illusion in Lease Financing*, 37 Harv. Bus. Rev. (No. 2) 121 (1959)	50
Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 Real Estate Law. J. 664 (1974)	50
Rev. Proc. 72-10, 1972-1 Cum. Bull 721	64
Rev. Proc. 75-21, Sec. 4(2) 1975-1 Cum. Bull. 715	49, 59
Rev. Rul. 55-540, 1955-2 Cum. Bull. 39	59
Rosenberg and Weinstein, *Sale-leasebacks: An analysis of these transactions after the* Lyon *decision*, 45 Journal of Taxation 146 (September 1976)	44, 49, 69

In the Supreme Court of the United States

OCTOBER TERM, 1977

No. 76-624

FRANK LYON COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The memorandum letter opinion and findings of fact and conclusions of law of the district court (Pet. App. A 1a-14a) are not reported. The opinion of the court of appeals (Pet. App. B 15a-30a) is reported at 536 F.2d 746.

JURISDICTION

The judgment of the court of appeals was entered on May 26, 1976 (Pet. App. C 31a). On August 6, 1976, the court of appeals clarified the final sentence of its opinion, but otherwise denied a petition for rehearing by petitioner with suggestion for rehearing

en banc (Pet. App. D 32a–33a). The petition for a writ of certiorari was filed on November 3, 1976, and was granted on February 22, 1977. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the transfer of title to a building to petitioner and petitioner's simultaneous long-term lease of the building back to the transferor was a financing transaction under which petitioner did not have any significant ownership interest or investment in the building that would entitle it to income tax deductions for mortgage interest and depreciation, where: (1) the lessee had an unconditional obligation during a 25-year term to pay rent exactly equal to the mortgage payments and had the option to extend the lease for 40 years at sharply reduced rents; (2) the lessee had the option to reacquire title to the building for an amount that was unrelated to its fair market value but was the sum of the cash advanced by petitioner, plus interest, and the balance of the mortgage loan; and (3) the lessee retained title to the underlying land.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

STATEMENT

This case involves the federal tax consequences of a sale-and-leaseback transaction in which petitioner took title to a building under construction by the Worthen Bank & Trust Company ("Worthen") of Little Rock, Arkansas, and simultaneously leased the building back to Worthen for long-term use as its headquarters and principal banking facility.

The pertinent facts are undisputed and are established by the trial testimony and the documentary evidence.

A. THE FACTUAL BACKGROUND

1. Petitioner is a closely-held corporation primarily engaged in distributing household electronic products (I–A. 19–20). In 1962, the Worthen Bank began to consider moving to new quarters in downtown Little Rock. Worthen thereafter engaged a real estate consulting firm which recommended that Worthen construct a new banking facility on urban renewal land

located in the downtown area of the city. In 1966, Worthen submitted a development plan to the Little Rock Housing Authority, the owner of the urban renewal property, and offered to purchase the parcel for $1,425,299.95 (I–A. 124–126, 129; Pltf. Ex. 1, II–A. 313–315). Prior to acquiring the land, Worthen had hired an architectural firm to prepare working drawings of a proposed headquarters building, and also entered into construction contracts (Pet. App. B 16a).

Worthen acquired the land and began construction on September 15, 1967. At that time, Worthen had already obtained a verbal commitment from First National City Bank of New York ("City Bank") for interim construction financing of the project (I–A. 129–130; Deft. Ex. 16, II–A. 742–748). As a result of its extensive discussions with various mortgage bankers, Worthen had also received a number of proposals for permanent financing (I–A. 126–127, 202–205; Deft. Ex. 16, II–A. 742–748).

Worthen originally hoped to finance the estimated $9 million cost of the land, building and parking facility by itself. Thus, in seeking approval for the project from the Federal Reserve Bank, Worthen showed the proposed building as an asset on a *pro forma* balance sheet (Pltf. Ex. 1, II–A. 320). However, the regulations of the Arkansas State Bank Department and the Federal Reserve Board required Worthen, as a state bank subject to their supervision, to obtain permission from them to invest an amount in banking

premises in excess of its $4,000,000 capital stock or 40 percent of its capital stock and surplus (I–A. 131).[1] See 12 U.S.C. 371d; 12 C.F.R. 265.2(f)(7). Thus, Worthen began to consider alternative methods of financing that would permit it to characterize itself on its books as a tenant rather than the owner of the building (I–A. 189; Deft. Ex. 13, II–A. 707).[2]

2. In September 1967, shortly before construction was started, Worthen formulated a new financing

[1] As of June 30, 1967, Worthen's capital stock was $4,000,000 and its surplus was $5,000,000 (Pltf. Ex. 1, II–A. 318). During the period in which the building was under construction, Worthen became a national bank under the supervision and control of the Comptroller of the Currency (I–A. 196–197).

[2] Worthen first considered creating a wholly-owned real estate subsidiary to hold title to the building and to lease it to Worthen (Pltf. Ex. 1, II–A. 313–314; Deft. Ex. 13, II–A. 707). Under this plan, the subsidiary would raise the necessary funds by issuing $4,000,000 in debentures and borrowing $5,000,000 under a conventional mortgage loan (I–A. 132–133; Deft. Ex. 13, II–A. 707; Deft. Ex. 16 I–A. 742–748). But this plan was abandoned because (1) the Federal Reserve Bank advised Worthen that an investment by such a subsidiary would be considered to be Worthen's own investment in banking premises (I–A. 133–134; Pltf. Ex. 37, II–A. 597); and (2) there was no market for the proposed debentures because of the interest rate limitations Arkansas law then imposed on state banks (I–A. 135; Pet. App. A 4a).

Counsel further advised Worthen that the Internal Revenue Service would regard Worthen as the owner of the building despite the fact that the subsidiary would hold title to it. In the opinion of counsel, the Service would treat the lease as a security agreement for the loan obtained by Worthen. The result of such a determination would be that Worthen could claim deductions for depreciation and interest but would not be allowed deductions for the rental payments to its subsidiary (Deft. Ex. 14, II–A. 708–715).

plan which involved a sale-and-leaseback arrangement (Pltf. Exs. 2, 3 and 4, II–A. 322–326; I–A. 136). Under this proposal, an institutional investor would purchase the land and construct the building and lease them to Worthen on a long-term basis.[3] Worthen would have an option to purchase the building after 15 years at an agreed-upon figure.[4] Worthen itself would make no capital investment in the building but would bear the cost of constructing the parking garage. On September 13, 1967, the Federal Reserve Bank advised Worthen that it had no objection to this proposal[5] (Pltf. Ex. 4, II–A. 326–327).

While the plan as initially approved by the Federal Reserve Bank called for sale of the land to an outside investor who would construct the building,

[3] Counsel advised Worthen that its proposed lease-and-option-to-purchase arrangement with an institutional investor would be recognized by the Internal Revenue Service as a "valid lease for Federal income tax purposes; and particularly so if the institutional investor finances the construction so that there is not a sale followed by a leaseback" (Deft. Ex. 15, II–A. 735–736). Counsel further emphasized that "[t]he rental payments appear to be the fair rental value * * * and most important, the option price will be substantially equal to the fair market value of the land and building at the time of its exercise" (*id.* at II–A. 737).

[4] The Arkansas State Bank Department required that such a leaseback arrangement provide for a repurchase-option at the end of the 15th year, but did not otherwise specify the terms of the agreement (Pet. App. A 4a).

[5] Worthen obtained approval from the Arkansas State Bank Commissioner for a similar plan, which called for Worthen itself to construct the building and then to enter into a sale-and-leaseback arrangement with an outside investor (Pltf. Exs. 5 and 6, II–R. 328–337).

Worthen wanted to maintain exclusive control and responsibility over the details of the building (I–A. 156–157). Worthen also recognized that it could save an estimated $125,000 in sales taxes on the materials to be incorporated in the building if it constructed the building itself because it was not subject to the Arkansas sales tax. (I–A. 32, 117–118; Deft. Ex. 16, II–A. 744). Thus, Worthen acquired title to the land and commenced construction work itself on September 15, 1967, prior to its completion of final financing arrangements (I–A. 128–130).[6]

Worthen thereafter commenced negotiations with the investment banking firms of Goldman, Sachs & Company, White, Weld & Co., Eastman Dillon, Union Securities & Company, and Stephens, Inc., with regard to providing $7,500,000 in financing required under the proposed sale-and-leaseback arrangement (I–A. 142; Pet. App. A 4a). Four of these firms made specific proposals to Worthen regarding the sale-and-leaseback plan of financing the new bank headquar-

[6] The Federal Reserve Bank, however, advised Worthen that it could not approve an arrangement under which Worthen built the building if, at any time, the interim construction financing shown on Worthen's balance sheet exceeded its capital stock of $4,000,000 (I–A. 139–140; Pltf. Ex. 38, II–A. 599–600). Worthen gave its assurances that it would not exceed this limitation (Pltf. Ex. 7, II–A. 338). Worthen thereafter adopted a plan by which the building was sold piece by piece to petitioner as it was constructed, so that the entire building never appeared on Worthen's books (I–A. 117–118; Pltf. Ex. 43, II–A. 620–621; Pet. App. B 18a n. 2).

ters (Pltf. Ex. 9, II–A. 340–343; Pltf. Ex. 10, II–A. 344–345; Pltf. Ex. 39, II–A. 601–608).[7]

In late October 1967, Worthen obtained a commitment from the New York Life Insurance Company to provide $7,140,000 of permanent mortgage financing on the building, conditioned upon its approval of the party nominated by Worthen to hold title to the

[7] Goldman, Sachs & Company submitted a sale-and-leaseback proposal involving both the land and building, which called for rentals of $571,430 annually over a 25-year primary term, based on a 6¾ percent interest rate on the amount financed (Pltf. Ex. 9, II–A. 340–343). Under this proposal, Worthen would enter into a "net" lease and have the same responsibilities "as if it had complete ownership" (Pltf. Ex. 9, II–A. 341). At the end of the primary term of the lease, Worthen would have the option to repurchase the property for an amount equal to the greater of its fair market value or 20 percent of the original cost of the property. Worthen would also have options to repurchase the property at its fair market value during the extended terms of the lease (Pltf. Ex. 9, II–A. 343).

Stephens, Inc. made a joint proposal with Eastman Dillon and Union Securities & Co. (Pltf. Ex. 39, II–A. 601–608). This proposal called for financing the new building through the issuance of collateral notes that would be sold to investors. The lease would be noncancelable for the first ten years and the rentals would be sufficient to repay the notes and interest and provide "a modest cash income" to the lessors (Pltf. Ex. 39, II–A. 603–605). Under this proposal, Worthen would have repurchase options, based on straightline depreciation over a forty-year useful life, as follows (Pltf. Ex. 39, II–A. 608):

Repurchase Option Date	*Difference: Repurchase Price Over Debt Balance*
15th year	133,835
20th year	1,108,781
25th year	2,887,500
30th year	1,925,000

To simplify the computation of the repurchase price, Stephens and Eastman Dillon suggested that it would be desirable for Worthen to continue to own the land underlying the building and parking deck (Pltf. Ex. 39, II–A. 602–603).

building (I–A. 149, 189; Pet. App. B 16a). At the same time, petitioner's majority shareholder and board chairman, Frank Lyon, who also served on Worthen's board of directors, learned of Worthen's proposed sale-and-leaseback transaction and entered the negotiations (I–A, 143–148, 254–255). On October 30, 1967, Lyon proposed that petitioner, his company, serve as the outside "investor" to hold title to the building under the sale-and-leaseback plan (Pltf. Ex. 11, II–A. 346–347). Lyon suggested annual rentals of $50,000 less than the mortgage payments on the building for the first ten years and an option for Worthen to repurchase the building after 15 years for $1,700,000 cash, plus the assumption of the unpaid mortgage balance (Pltf. Ex. 11, II–A. 346).

On October 31, 1967, after incorporating what it believed to be the "best part" of each proposal, Worthen made a counter-proposal to Goldman Sachs, Stephens, Inc. and petitioner (I–A. 143–144; Pltf. Ex. 12, II–A. 348; Pltf. Ex. 13, II–A. 349–351). Worthen's counter-proposal called for the investor to supply an "equity" of $500,000, which would bear "interest" compounded at the rate of six percent per year (Pltf. Ex. 13, II–A. 350; Pet. App. B 17a). Interim construction financing would be supplied by City Bank (I–A. 149; Pltf. Ex. 13, II–A. 349–350) and the permanent financing would be supplied by New York Life at 6¾ percent payable over 25 years.

Worthen proposed to bear all of the costs in maintaining the building under a "net" lease with the investor, with "rentals" to be paid by Worthen over

the 25-year initial term of the lease precisely equal to the amounts required to amortize the New York Life loan over the same period (Pet. App. A 5a). Worthen would retain ownership of the land and lease it to the investor for a nominal rent during the initial term of the building lease. Worthen would also have an option to repurchase the building at the end of the 11th, 15th, 20th and 25th years, with the option prices to be the sum of: (1) the assumption of the unpaid balance of the mortgage; and (2) the $500,000 advance made by the investor, with interest compounded at an annual rate of six percent (Pet. App. B 19a; I–A. 79–81; Pltf. Ex. 13, II–A. 350–351). On November 1, 1967, after petitioner accepted Worthen's counterproposal, Worthen selected petitioner to serve as the "investor."[8]

[8] As an additional inducement to Worthen, petitioner agreed to reduce Worthen's rent on the building by $21,000 per year below the mortgage payments for the first five years of the lease (I–A. 42, 71; Pltf. Ex. 14, II–A. 352; Pet. App. A 5a; Pet. App. B 17a–18a). But New York Life would not accept an assignment of a lease providing for a reduction in rent of $21,000 per year less than the principal and interest payments due on the mortgage. As a result, Worthen and petitioner entered into a lease at rentals precisely equal to the mortgage payments, as Worthen had originally proposed (I–A. 109–111; Pet. App. B 17a).

By separate agreement, however, petitioner agreed to provide for the $105,000 ($21,000×5) reduction in rent by paying Worthen an interest rate three percent greater than its usual borrowing rate from Worthen on a subsequent $500,000 loan from Worthen in August 1969. As of trial, Worthen had not required repayment of this one-year demand note (Pet. App. B 17a–18a n. 1). The testimony indicated that Worthen had treated this loan more favorably than other loans that Worthen has made to petitioner (I–A. 59–70).

B. THE TERMS OF THE SALE-AND-LEASEBACK ARRANGEMENT

In May 1968, petitioner, Worthen, City Bank, and New York Life executed a set of inter-locking agreements with respect to the sale-and-leaseback of the bank building whereby Worthen "sold" its building as it was constructed to petitioner and Worthen then "leased back" the building from petitioner (I–A. 29–30; Pet. App. B 18a).[9] The terms of these agreements can be summarized as follows.

1. *Agreements Between Petitioner and Worthen.*— Petitioner and Worthen executed a sales agreement, a ground lease, and a building lease. Pursuant to the sales agreement of May 19, 1968 (Pltf. Ex. 25, II–A. 508–522), Worthen sold to petitioner all of the mechanical, electrical and structural components (but not the interior) of the building as they were constructed, for a price not to exceed $7,640,000 in "reimbursements" for expenditures incurred by Worthen for the construction of the building (I–A. 45–46, 237–238; Pltf. Ex. 25, Sec. 2, II–A. 511–514).[10] Worthen

[9] In November 1967, subject to various guarantees, assignments, warranties and representations made by Worthen, City Bank and New York life agreed to the sale-and-leaseback arrangement between Worthen and petitioner under which they would respectively provide the interim construction financing and the permanent mortgage (Pltf. Exs. 16, 17, II–A. 356–362). In April 1968, Worthen obtained the approval of the Arkansas State Bank Department and the Federal Reserve Bank for the transaction (Pltf. Exs. 40–44; II–A. 609–622).

[10] Worthen determined the sales price by subtracting its allowable $4,000,000 capital investment in the project from the estimated total cost of the building (I–A. 44, 189; Pltf. Ex. 43, II–A. 620–621).

agreed to indemnify petitioner from all claims arising out of Worthen's failure to complete construction of the building by the closing date of December 1, 1969 (Pltf. Ex. 25, Secs. 3(j), 7, II–A. 516–517, 520).

Under the ground lease dated May 1, 1968, Worthen agreed to lease the underlying land to petitioner for 76 years and seven months. For the first 25 years, the ground rent was to be $50.[11] Thereafter, the annual ground rent payable by petitioner to Worthen would be sharply increased as follows (Pltf. Ex. 18, Sec. 3, II–A. 367–368):

12-1-1994 thru 11-30-1999 (5 years)	$100,000
12-1-1999 thru 11-30-2004 (5 years)	150,000
12-1-2004 thru 11-30-2009 (5 years)	200,000
12-1-2009 thru 11-30-2014 (5 years)	250,000
12-1-2014 thru 11-30-2034 (20 years)	250,000
12-1-2034 thru 11-30-2044 (10 years)	10,000

Under the building lease dated May 1, 1968 (Pltf. Ex. 19, II–A. 376–442), petitioner agreed to lease the building back to Worthen for a primary term of 25 years, with options for Worthen to extend the lease for eight additional five-year terms (Pltf. Ex. 19, Secs. 1, 2, 2.1 II–A. 377–378). Worthen was not obligated to pay rent until December 1, 1969, the date of expected completion of the building. From that date

[11] The testimony at trial was that the fair rental value of the underlying land in 1968 was $100,000 a year (I–A. 169, 249). However, Worthen agreed to charge petitioner a nominal ground rent during the initial 25-year term of the ground lease (when the New York Life mortgage was outstanding) because petitioner would have passed the cost of any higher ground rent back to Worthen in the form of an increased building rent (I–A. 169) (See also Pet. App. B 19a, n. 3).

until November 30, 1980, the lease provided that Worthen's annual rent would be $582,324; thereafter until November 30, 1994, the annual rent was $613,156 (Pltf. Ex. 19, Sec. 3.1, II–A. 378–379).

These rentals during the primary 25-year term were exactly equal to the principal and interest payments under the $7,140,000 New York Life mortgage that would amortize that loan over the same period (I–A. 76, Pet. App. A 5a; Pet. App. B 18a–19a; Deft. Ex. 7, II–A, 697–700). As required by New York Life (Pltf. Ex. 17, II–A. 364), the building rent was payable to petitioner or its assignee on an absolutely net basis without any deduction, counterclaim or setoff (I–A. 101; Pltf. Ex. 19, Secs. 3.2, 5.1, II–A. 379, 380–381; Pltf. Ex. 29, Sec. 5, II–A. 582).

During the eight five-year extended terms of the lease, when the New York Life loan would be paid off, the annual building rent was reduced to $300,000. However , this diminished rent was further decreased by petitioner's obligation to pay greatly increased ground rent to Worthen after 25 years.[12] Thus, while Worthen's net rent for the last year of the primary term was $613,154 ($613,156 minus $2 ground rent), its net rent for the first year of the extended term was reduced to $200,000 ($300,000 minus $100,000 ground rent). The rent was correspondingly reduced during the extended period so that during the last 25 years of the extended term, the net annual rent payable by

[12] The ground lease would terminate if Worthen did not renew the building lease or if it exercised its option to purchase the building (Pltf. Ex. 18, Sec. 9, II–A. 369).

Worthen was only $50,000 ($300,000 minus $250,000 ground rent (I–A. 168–170; Pet. App. B 19a n. 3).[13]

As a result, the net rent payable by Worthen during the primary term of the lease was approximately eight percent of the $7,640,000 cost of the building; however, the net rent during the extended terms ranged from 2.6 percent to 0.6 percent of the cost of the building. Finally, the net amounts payable over the extended terms of the lease approximated the amount required to repay petitioner's $500,000 investment at six percent compound interest (Pet. App. B 26a–27a).

The building lease was a net lease. Thus, Worthen bore all costs, risks and responsibilities for the building, such as repairs, maintenance, taxes, utilities and insurance (Pltf. Ex. 19, Secs. 7.1, 9.1, 12, 14, II–A. 382–389, 391–395; I–A. 99–105, 213–214).[14] Any condemnation award or insurance proceeds arising from the total destruction of the building were to be applied first to discharge the full amount of the New York

[13] Edward M. Penick, Worthen's president and a member of its new building finance committee, testified that the net building rentals payable by Worthen during the extended term were a "very, very cheap price" (I–A. 168). C. V. Barnes, petitioner's real estate appraiser, described the rental terms on the building after 1994 as being "favorable to the bank" (I–A. 251). Likewise, petitioner's board chairman, Frank Lyon, characterized these same rents as "low" (I–A. 261).

[14] Worthen further agreed to indemnify petitioner for any claims connected with the building, and agreed to repair any damage to the building and to pay rent notwithstanding any such damage (Pltf. Ex. 19, Secs. 11, 13, 17.1, 17.3, II–A. 385–386, 389–391, 404, 407–408).

Life mortgage, then to petitioner in accordance with a "Termination Table,"[15] and any remaining amount to Worthen (Pltf. Ex. 19, Secs. 17.6, 18.4, Table A, II–A. 408–410, 415–417, 439–442; Pet. App. B 20a–21a).

Finally, pursuant to the lease, petitioner gave Worthen an option to repurchase the building exercisable at stated intervals and prices as follows (Pltf. Ex. 19, Sec. 20.1, II–A. 419):

Option date	*Price*
November 30, 1980 (11th year)	$6,325,169.85
November 30, 1984 (15th year)	5,432,607.52
November 30, 1989 (20th year)	4,187,328.04
November 30, 1994 (25th year)	2,145,935.00

In accordance with Worthen's original specification for the sale-and-leaseback arrangement (Pltf. Ex. 13, II–A. 350), the repurchase option prices were the sum of: (1) the assumption of the unpaid balance of the New York Life mortgage, (2) a return of petitioner's $500,000 advance; and (3) six percent interest compounded on the $500,000 advance (I–A. 74–76, 249; Pet. App. B 19a).[16]

[15] The "termination table" set forth the repurchase option prices. As the court below noted, the table was geared to provide a return of petitioner's $500,000 investment at six percent interest compounded annually (Pet. App. B 20a; Pltf. Ex. 19, Table A, II–A. 439–442).

[16] The amounts payable by Worthen over and above the unpaid mortgage balance on the exercise of these options were as follows (Pltf. Exs. 13, 40, 41; II–A. 350, 611, 615):

Nov. 30, 1980	$800,000
Nov. 30, 1984	1,000,000
Nov. 30, 1989	1,603,568
Nov. 30, 1994	2,145,935

2. *Construction Financing Agreements.*—By agreement dated May 14, 1968, City Bank agreed to lend petitioner $7 million for the construction of the Worthen Building that had begun in September, 1967 (Pltf. Ex. 21, II–A. 462). The loan was secured by a mortgage on the building, pursuant to which both petitioner and Worthen conveyed title to the building, land, and parking facility to City Bank as security for the construction loan (Pltf. Ex. 23, II–A. 490–502). As additional security, petitioner assigned its interest in the building lease and ground lease (Pltf. Ex. 24, Sec. 2, II–A. 505). If City Bank's construction loan was not fully repaid by December 1, 1969, Worthen guaranteed that it and petitioner would enter into a new building lease that would provide for sufficient rentals to amortize the loan in a manner acceptable to City Bank (Pltf. Ex. 35, II–A. 592; Pet. App. B 18a, n. 2).[17]

By means of a separate letter agreement, Worthen also reserved the right to repurchase the building at a negotiated price in the event Frank Lyon, his immediate heirs or current working associates, proposed to sell their stock in petitioner to someone who was unacceptable to Worthen (I–A. 173–174; Pltf. Ex. 50, II–A. 686; Pet. App. B 21a n. 5). The negotiated repurchase price was related to Worthen's favorable option prices and low extended term rentals in the building lease (I–A. 250–251; Pet. App. B 26a).

[17] The disbursements of the interim construction funds from City Bank of New York were accomplished as follows: After receipt of an architect's certificate, an independent certified public accountant's opinion, and an affidavit from an officer of Worthen that certain work had been performed, petitioner would present these documents to City Bank for an advance on the $7,000,000 construction loan (I–A. 45–46; Pltf. Ex. 21, II–A. 465–467; Pltf.

3. *Permanent Financing Agreements.*—New York Life agreed to purchase a $7,140,000 6¾ percent secured note issued by petitioner upon the completion of the building on December 1, 1969 (Pltf. Exs. 20, 26, II–A. 443–461, 523–526). Under the note-purchase agreement, petitioner warranted that it would lease the building to Worthen for a non-cancelable term of at least 25 years under an absolutely net lease at a rent at least equal to the mortgage payment on the note (Pltf. Ex. 17, II–A. 360, 364; Pltf. Ex. 20, Sec. 4C, II–A. 449). Petitioner agreed to make annual payments of principal and interest of $582,324 for the first 11 years and $613,156 for the next 14 years (Pltf. Ex. 26, II–A. 523–526). These amounts were exactly equal to the rentals payable by Worthen during the corresponding 25-year primary term of the lease. See pp. 12–13, *supra*. To the extent that the rental payments exceeded the interest on the New York Life mortgage and amortized the loan, they reduced the option price on a dollar-for-dollar basis (Pet. App. B 26a).

Ex. 25, II–A. 511–514). Petitioner would then write a check for the amount of the advance received from City Bank of New York and deposit it for the credit of Worthen in an account of Worthen's or at another bank (I–A. 45, 55, 75; Pltf. Ex. 32, II–A. 584–586). When the building was completed on December 1, 1969, the $7 million construction financing loan from City Bank of New York was repaid from the proceeds of the permanent loan of $7,140,000 advanced on the same date by New York Life (I–A. 47). The remaining $500,000 in financing was supplied by petitioner (I–A. 217–218; Pltf. Ex. 13, II–A. 350). Worthen's actual cost of constructing the office building and parking complex (excluding the land) exceeded $10 million (Deft. Ex. 11, II–A. 701–704).

Although petitioner was designated as the formal borrower on the New York Life note, both petitioner and Worthen provided New York Life with security for the payment of the loan. Pursuant to the deed of trust, petitioner conveyed to New York Life title to the building and assigned all of its rights and interest in the building and ground leases to secure payment of the note (Pltf. Ex. 27, II–A. 528–529).[18] Worthen consented to petitioner's assignment of the building lease to New York Life and agreed to make all required payments to New York Life (Pltf. Ex. 29, II–A. 582; Pet. App. B 18a). Worthen also pledged the land, parking facility, and its ownership interest in the air space and certain easements in the building as additional security (Pltf. Ex. 27, II–A. 529).

C. THE PROCEEDINGS BELOW

On its income tax return for 1969, petitioner reported the payments Worthen made to it under the building lease as rental income, and claimed deductions for depreciation on the Worthen Building, mortgage interest paid on the interim and permanent loans, and other expenses in connection with the construction of the building. On audit, the Commissioner of Internal Revenue determined that petitioner was not the owner of the Worthen Building for federal tax purposes. The Commissioner determined that the sale-and-leaseback arrangement was a financing trans-

[18] As further security for the loan, petitioner assigned to New York Life its power to modify or terminate the building lease to Worthen (Pltf. Ex. 28, Sec. 5, II–A. 574).

action in which petitioner loaned Worthen $500,000 and acted as a conduit for the transmission of principal and interest from Worthen to New York Life. Accordingly, the Commissioner disallowed petitioner's claimed deductions for depreciation, interest, and other expenses, and excluded the rental income reported by petitioner from its gross income (Pltf. Ex. 52, II–A. 689; Pet. App. A 7a–8a; Pet. App. B 21a).[19]

In this refund suit brought by petitioner in the United States District Court for the Eastern District of Arkansas to recover the additional taxes it paid as a result of the Commissioner's assessment, the district court held that petitioner was entitled to be treated as the owner of the building for purposes of claiming deductions for mortgage interest and depreciation (Pet. App. A 1a–3a). In the district court's view, the intent of the parties, as expressed by the written instruments, was to accomplish a sale-and-leaseback of the building with an option to Worthen to repurchase it (Pet. App. A 1a–2a).

The court of appeals unanimously reversed (Pet. App. B 15a–30a). It held that the Commissioner correctly determined that petitioner was not the true owner of the building and therefore was not entitled to depreciation or mortgage interest deductions.

In support of its conclusion, the court cited, *inter alia*, the following facts: (1) The lease agreements

[19] Consistent with his determination against petitioner, the Commissioner allowed Worthen deductions for depreciation and mortgage interest, and disallowed Worthen's claimed deductions for rent (I–A. 219).

circumscribed petitioner's right to profit from its investment in the building by giving Worthen the option to purchase the building at stated intervals for $500,000 (the amount of petitioner's equity), plus six percent compounded interest, and to assume the unpaid balance of the New York Life mortgage; (2) the option prices did not take into account possible appreciation of the value of the building or inflation; (3) any award realized as a result of the destruction or condemnation of the building in excess of the mortgage balance and petitioner's $500,000 investment would be paid to Worthen and not petitioner; (4) the building rental payments during the 25-year primary term were exactly equal to the mortgage payments so that petitioner merely served as a conduit by which the mortgage payments would be transmitted to New York Life; (5) Worthen retained control over the ultimate disposition of the building through its various options to repurchase and to renew the lease plus its ownership of the underlying land; and (6) Worthen enjoyed all benefits and bore all burdens incident to the operation and ownership of the building so that the only economic advantage accruing to petitioner, in the event it were considered to be the true owner of the property, were income tax savings of $1.5 million during the first 11 years of the arrangement (Pet. App. B 25a–28a).

In light of these facts, the court concluded that (Pet. App. B 28a) "[t]he overall nature of this transaction is closely akin to that in *Helvering* v. *F. & R. Lazarus & Co.* [308 U.S. 252]" where this Court held that under an essentially-identical arrangement, the purported seller-lessee was the true owner of property for federal tax purposes. In accordance with the rule established in *F. & R. Lazarus Co.*, the court of appeals therefore held that "the benefits, risks, and burdens which * * * [petitioner] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes" (Pet. App. B 29a).[20]

SUMMARY OF ARGUMENT

I

1. The court of appeals correctly held that under this Court's decision in *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252, the sale-and-leaseback transaction at issue in this case did not confer upon petitioner any significant ownership interest in the building that would entitle petitioner to income tax deductions for mortgage interest and depreciation. In *Lazarus*, this Court unanimously held that the taxpayer could disregard the form of a sale-and-leaseback transaction where the economic benefits and burdens of ownership were retained by the purported seller-lessee, whose payment of "rentals" simply served to amortize the mortgage loan on the property. Thus, the Court permitted the seller-lessee to claim depreciation deduc-

[20] On petitioner's petition for rehearing, the court of appeals modified its opinion to provide for a remand to the district court for further findings with respect to petitioner's claimed deductions for interest on the interim construction loan and for miscellaneous additional expenses in connection with these agreements (Pet. App. D 32a–33a).

tion on real property nominally titled in the lessor. Here, in a transaction that the court of appeals recognized to be "closely akin" (Pet. App. B 28a) to that in *Lazarus,* the decision below properly permitted the Commissioner likewise to disregard the form in favor of the economic substance of the arrangement and to disallow petitioner's claimed interest and depreciation deductions.

As in *Lazarus,* the nominal seller of the property (the Worthen Bank) remained in possession of the premises and paid rentals calculated to provide a fixed return on the purported purchaser's investment. The "rental" payments made by Worthen exactly equaled petitioner's principal and interest payments on the New York Life mortgage (Pet. App. B 18a–19a). Moreover, Worthen had an absolute obligation to make the rental payments and it agreed that it would not cancel the lease as long as the mortgage was outstanding (Pet. App. B 18a). Moreover, it was impossible for Worthen toterminate the arrangement because it expressly consented to the assignment of petitioner's iterestin the lease as security for the loan.

Thus, Worthen's role in the transaction was identical to that of a mortgage debtor who has an absolute obligation to make payments to the mortgage lender over the life of the mortgage. In substance, Worthen mortgaged the building; petitioner's role was at best that of a conduit to forward Worthen's mortgage payments, cast in the form of "rentals," to the mortgagee, New York Life. Indeed, Worthen agreed to transmit

the "rent" directly to the mortgagee without even involving petitioner. Under these circumstances, petitioner is not entitled to deductions for mortgage interest and depreciation because it had no ownership interest or investment in the property.

Moreover, the repurchase options retained by Worthen further demonstrate that petitioner did not bear any of the benefits and burdens of ownership. Here, as in *Lazarus,* the purported seller-lessee (Worthen) had the option to repurchase the property for an amount equal to the unpaid mortgage balance and petitioner's investment, plus interest (see Pet. App. B 19a). At stated intervals during the term of the agreement, Worthen could have stepped into the shoes of petitioner and acquired title to the building simply by assuming the mortgage and repaying petitioner's $500,000 investment plus interest. Since petitioner did not stand to benefit from any appreciation in the value of the building or stand to suffer any loss from any decrease in its value (unless the value fell below the option price), it did not own the building in any realistic sense of the word.

2. Petitioner seeks to minimize the significance of the option to repurchase by citing the district court's finding (Pet. App. A 6a) that it was unlikely that Worthen would exercise the option. But as the court of appeals correctly recognized (Pet. App. B 19a), the reason why Worthen might not exercise its option to repurchase at the end of the primary term, if not before, is that it had the right to occupy the building

for an additional 40 years, retaining all of the benefits of ownership, at drastically reduced rentals, which Worthen's president conceded were a "very, very cheap price" (I–A. 168). These bargain rentals would repay petitioner its $500,000 investment with a return of slightly less than six percent compounded interest. Moreover, since Worthen retained title to the underlying land, it was assured, in any event, of recovering absolute possession and ownership of the property on the expiration of the ground lease a relatively short time after the end of the extended term of the building lease. The district court's finding with respect to the likelihood of Worthen's exercise of the option and the reasonableness of the rents during the *primary* term are therefore irrelevant.

Petitioner's ready acceptance of an arrangement in which it had no significant prerogatives of ownership can only be explained in terms of the benefit of the substantial depreciation deductions it would receive if the tax consequences followed the form of the arrangement. Worthen's dictation of all the terms of the transaction and petitioner's willingness to reduce the building rent below the amount proposed by Worthen belies petitioner's characterization of the arrangement as the product of "hard, arms-length bargaining."

If, as the court of appeals noted (Pet. App. B 24a), the various obligations and rights of ownership are analogized to a "bundle of sticks," it is clear that Worthen held most, if not all, of the "sticks" and petitioner few or none. Since it is virtually inconceivable that Worthen would simply walk away from its

investment in this building at the end of 25 years after it had fully paid for its construction (except for the return of petitioner's $500,000 investment), the only risk borne by petitioner was that Worthen would become insolvent. But that is nothing more than the risk which would be borne by the guarantor of a loan rather than the owner of real property. The court of appeals therefore correctly held that Worthen, and not petitioner, was the actual owner of the building. Accordingly, Worthen and not petitioner is entitled to claim deductions for mortgage interest and depreciation with respect to the building.

II

The court of appeals correctly held that the ultimate characterization of a sale-and-leaseback arrangement for tax purposes is a question of law that is freely reviewable on appeal. While results may differ in accordance with the details of a given transaction, the arrangements in these cases are spelled out in undisputed written documents that call for legal interpretation under the economic substance standard of *Lazarus*. Testimonial evidence concerning the "intent" of the parties is accordingly irrelevant.

The court of appeals therefore properly disregarded the district court's finding that the parties subjectively intended a true sale. In this respect, its decision is in accord with the decisions of other courts of appeals that have held that the question whether such agreements are true sales or financing transactions is one of law. *American Realty Trust* v.

United States, 498 F. 2d 1194, 1198 (C.A. 4); *Estate of Franklin* v. *Commissioner,* 544 F. 2d 1045, 1047 n. 3 (C.A. 9); *American National Bank of Austin* v. *United States,* 421 F. 2d 442, 451 (C.A. 5), certiorari denied, 400 U.S. 819; *Union Planters National Bank of Memphis* v. *United States,* 426 F. 2d 115, 117–118 (C.A. 6), certiorari denied, 400 U.S. 827; *Oesterreich* v. *Commissioner,* 226 F. 2d 798, 801–802 (C.A. 9).

ARGUMENT

I

THE SALE AND LEASEBACK ARRANGEMENT IN THIS CASE WAS A FINANCING TRANSACTION UNDER WHICH PETITIONER DID NOT HAVE ANY SIGNIFICANT OWNERSHIP INTEREST OR INVESTMENT IN THE BUILDING THAT WOULD ENTITLE IT TO TAX DEDUCTIONS FOR MORTGAGE INTEREST AND DEPRECIATION

A. THE ECONOMIC SUBSTANCE OF SALE AND LEASEBACKS IS CONTROLLING FOR FEDERAL TAX PURPOSES

1. This case involves an application of the well-settled principle announced by this Court almost 50 years ago that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss* v. *Bowers,* 281 U.S. 376, 378. In numerous cases, the Court has refused to permit the transfer of legal title to property to shift the incidents of taxation attributable to the ownership of the property where the transferor retains significant control

over the property transferred. See, *e.g., Commissioner* v. *Sunnen,* 333 U.S. 591; *Helvering* v. *Clifford,* 309 U.S. 331.

In applying this principle, commonly referred to in the literature as the doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than the particular form in which the parties organized the transaction. The parties to such arrangements generally select forms designed to achieve particular tax consequences. Thus, for example, if they seek to have their arrangement treated as a sale, the parties will use the words "sale" and "sales agreement;" if they wish certain payments to be characterized as "rent," they will execute a "lease."

But the Court has never regarded "the simple expedient of drawing up papers" (*Commissioner* v. *Tower,* 327 U.S. 280, 291) as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering* v. *F. & R. Lazarus & Co.,* 308 U.S. 252, 255. See also *Commissioner* v. *P. G. Lake, Inc.,* 356 U.S. 260, 266–267; *Commissioner* v. *Court Holding Co.,* 324 U.S. 331, 334. Nor is the parties' desire to achieve a particular tax result relevant. As the Court stated in *Commissioner* v. *Duberstein,* 363 U.S. 278, 286, "[i]t scarcely needs adding that the parties' expectations or hopes as to the tax treatment

of their conduct in themselves have nothing to do with the matter."

2. While the transaction in this case is complicated by an elaborate set of legal arrangements, its essential elements can be illustrated by the following two examples. Suppose A owns a building that is worth $100,000 and wishes to sell it to B at that price. B does not have the entire $100,000, but offers to put up $20,000 and obtain a mortgage from an outside lender for the $80,000 difference. The transaction is concluded on that basis and B takes title to the buildings, subject to the mortgage, to do with it as he sees fit—either to rent it to a tenant of his choice, to sell it, to occupy it himself, or simply to hold it in the hope that the building or the underlying land will appreciate in value.

In such a case, no one would doubt that there has been a "sale" and that B "owns" the building for tax purposes as well as for any other purpose. "A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent," *Iowa* v. *McFarland,* 110 U.S. 471, 478; it is a contract "to pass rights of property for money—which the buyer pays or promises to pay to the seller * * *." *Williamson* v. *Berry,* 8 How. 495, 544. In the parlance of real estate, B enjoys the "benefits" and bears the "burdens" of ownership because he will realize any appreciation or suffer any decrease in the value of the property.

But suppose the following variation on the foregoing example. A enters into a "sales agreement" to

sell the building to B for $100,000 and B puts up $20,000 and agrees to obtain an $80,000 mortgage. B thereafter leases the building back to A for a term equal to the term of the mortgage and for a net rental exactly equal to the mortgage payments. Moreover, B gives A an option to reacquire the building during the term of the lease for a price equal to the unpaid mortgage balance and the $20,000 plus interest. After the lease expires and the mortgage is paid off, A has an option to reacquire the building for B's investment of $20,000 plus interest.

After the expiration of the lease and the satisfaction of the mortgage, B is theoretically free to dispose of the building as he sees fit just as in the first example. But B's theoretical ownership at that point in time must be viewed in the context of A's option to reacquire the property. A, of course, may not exercise the option. However, if the $20,000 option price is below the fair market value of the building, it is highly unlikely that A will not exercise the option. Since A has in effect "paid off' the mortgage through his rentals, the relatively nominal option price, as compared with the original cost of the building, makes a compelling economic case for the exercise of A's right of reacquisition.

The likelihood that A will step into B's shoes at the termination of the arrangement therefore is incompatible with the conclusion that B "owns" the building. Indeed, B can hardly be said to "own" the building because there is no realistic way that he can benefit from any appreciation of the property or suffer any

detriment from its decrease in value unless the value of the building falls below $20,000 plus the interest factor. Like any lender, B can only expect to receive his original $20,000 plus interest at a fixed rate.

Thus, the net effect of the transaction is nothing more than a loan of $20,000 by B to A that will earn a fixed rate of interest.

3. Stripped to its essentials, the Worthen Bank and petitioner respectively stand in the place of A and B in the second example. Here, like B, petitioner put up $500,000 and purported to purchase a building from the Worthen Bank and lease it back to Worthen for a 25-year primary term equal to the duration of the mortgage and for a "rent" exactly equal to B's mortgage payments. But while the arrangement was cast in the form of a sale and leaseback, the fact that in substance it was only a financing transaction is demonstrated by the terms of the repurchase options and lease renewals.

At stated intervals during the primary term, Worthen could reacquire the building simply by satisfying the mortgage debt and paying petitioner its $500,000 advance plus interest compounded at six percent, regardless of the fair market value of the building at the time Worthen exercised the option. Similarly, when the mortgage was paid off, Worthen could extend the lease at drastically reduced bargain rentals that likewise bore no relation to the fair rental value but were simply calculated to pay petitioner its $500,000 plus six percent compounded interest over the

extended term. Thus, petitioner's return on the arrangement could in no event exceed six percent compound interest. Moreover, the favorable option and lease renewal terms made it highly unlikely that Worthen would abandon the building after it in effect had "paid off" the mortgage.

4. Given the limited financial return from such a long-term arrangement, the question naturally arises why petitioner would enter into such an elaborate sale-and-leaseback transaction when it could have loaned the Worthen Bank $500,000 at six percent compound interest in a simple and straightforward manner. The answer lies in the tax laws, which permit a deduction for business rent (Section 162(a) of the Code), mortgage interest (Section 163) and depreciation (Section 167). If the parties could convince the tax collector to accept the form of the arrangement under which petitioner "owned" the building and Worthen "leased" it, Worthen could deduct the entire amount of its payments to petitioner as "rent," despite the fact that petitioner in reality was no more than a conduit who transmitted them on to the mortgage lender. Moreover, petitioner could in turn claim depreciation deductions (based on the cost of construction ultimately borne by Worthen) which it could offset against its other income, and deduct mortgage interest which would roughly offset the inclusion in its income of Worthen's rental payments.

But, if, as we submit and as the court of appeals held, the arrangement was a financing transaction un-

der which Worthen was the owner of the building, Worthen's payments would only be deductible to the extent that they represented mortgage interest and Worthen would be entitled to claim depreciation deductions with respect to the building. On the other hand, petitioner would not be entitled to deductions for either mortgage interest or depreciation. Moreover, petitioner need not include Worthen's "rent" payments in its income because its function with respect to those payments was that of a conduit between Worthen and the mortgagee.

B. *HELVERING* V. *F. & R. LAZARUS & CO.*, 308 U.S. 252, CONTROLS THIS CASE

1. The foregoing analysis is supported by this Court's decision in *Helvering* v. *F. & R. Lazarus & Co., supra,* the seminal precedent that controls this case. There, the Court considered the tax consequences of an essentially equivalent sale-and-leaseback arrangement and held that it was in reality a loan on the security of the property.

In *Lazarus,* the taxpayer, a department store, purported to sell its business property for cash to a bank, which was acting on behalf of the holders of certain land trust certificates. The bank simultaneously leased the property back to the taxpayer for 99 years. It also gave the taxpayer a right to renew the lease for a similar term. The rent was based upon an annual return of five percent on the cash advanced by the bank and was less than a fair rental for the property. In addition to the rent, the taxpayer was further obliged

to make periodic payments to a "depreciation fund" until the fund, with accumulated interest, equaled the cash put up by the bank.

Finally, the bank gave the taxpayer an option to reacquire the property at the call prices of the trust certificates, the aggregate of which were far below the fair market value of the property. Upon the taxpayer's exercise of the option, the amounts it paid into the depreciation fund would be credited against the option price. In the event the taxpayer did not exercise the option, the depreciation fund would become the property of the certificate holders.[21]

This Court unanimously upheld the Board of Tax Appeals' conclusion that the taxpayer's transfer of title to the bank was in reality a mortgage so that the taxpayer could continue to claim depreciation deductions with respect to the property. In the Board's analysis, the nominal rent stipulated in the lease-back showed that the "rent" was nothing more than interest payable on the bank's loan to the taxpayer. In this respect, the "depreciation fund" to which the taxpayer was required to make payments was the mechanism for amortizing the loan. Finally, the minimal option prices and the dollar-for-dollar reduction of those prices by the taxpayer's amortization payments demonstrated that the taxpayer's exercise of the option was virtually inevitable. For whether or not the taxpayer exercised the option, the amortization pay-

[21] The facts are set forth in detail in the opinion of the Board of Tax Appeals (*F. and R. Lazarus & Co.* v. *Commissioner*, 32 B.T.A. 633).

ments belonged to the bank. Thus, the option price was the difference between the call price of the trust certificates and the amortization fund. Since the taxpayer was in all events required to make all of the amortization payments to the fund, it would have been highly unlikely that it would have forfeited its right to reacquire the property for failure to pay the nominal additional amount prescribed under the arrangement.

Under these circumstances, this Court agreed that "the Board justifiably concluded from its findings that the transaction between the taxpayer and the trustee bank, in written form a transfer of ownership with a lease-back, was actually a loan secured by the property involved" (308 U.S. at 255). As the Court observed, "General recognition has been given the 'established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money' [footnote omitted]" (*ibid.*). In so holding, the Court rejected the contention that the statutory right to depreciation follows legal title.[22]

2. The facts of the sale-and-leaseback arrangement at issue in this case confirm the correctness of the court of appeals' conclusion that the transaction was "closely akin to that in *Helvering* v. *F. & R. Lazarus & Co.*, * * *" (Pet. App. B 28a). Here, as in *Lazarus*, the nominal seller of the property (Worthen Bank)

[22] The District of Columbia Circuit had ruled that depreciation deductions could only be claimed by the title holder. *City National Bank Building Co.* v. *Helvering*, 98 F. 2d 216, 217 (C.A.D.C.).

remained in possession of the premises and paid rentals calculated to provide a fixed return on the purported purchaser's (petitioner's) investment. During the primary term of the lease, the "rental payments" made by Worthen exactly equaled petitioner's principal and interest payments on the New York Life mortgage (Pet. App. B 19a). Worthen had an absolute obligation to make the rental payments without any right of set-off or counterclaim, even if the building were destroyed (Pltf Ex. 19, Secs. 3.2, 5.1, II–A. 379–381; Ptlf. Ex. 29, Sec. 5, II–A. 582). It further agreed that it would not cancel the lease as long as the mortgage was outstanding (Pet. App. B 18a).

Moreover, Worthen could not terminate the arrangement because it expressly consented to the assignment of petitioner's interest in the lease as security for the New York Life loan (Pltf. Ex. 29, Sec. 5, II–A. 582). As additional security for the loan, petitioner assigned to New York Life its power to modify or terminate the building lease to Worthen. The parties were therefore locked into the arrangement at least for the primary term of the lease, in order to guarantee the payment of the New York Life loan.

Accordingly, Worthen's role in the transaction was identical to a mortgage debtor who has an absolute obligation to make payments to the mortgage lender over the life of the mortgage. In substance, Worthen mortgaged the building; petitioner's role in the transaction was nothing more than a conduit through which Worthen's mortgage payments, cast in the form of "rentals," were forwarded to New York Life.

Indeed, in consenting to the assignment of the building lease, Worthen agreed that payment of the rent would "be made directly to * * * [New York Life] so long as the Assignment shall continue in force * * *" (Pltf. Ex. 29, Sec. J, II–A. 582). This provision suggests that petitioner was not even a conduit but simply a nominal title holder. But as the Fifth Circuit admonished in *Holbrook* v. *Commissioner*, 450 F. 2d 134, 141, "The mere transfer of bare legal title to property is not enough to constitute a 'sale' for income tax purposes if the transferor continues to exercise virtually all his former control, and stands in the same economic position as he did prior to the transfer. See Helvering v. Clifford, 309 U.S. 331, 60 S. Ct. 554, 84 L. Ed. 788 (1940); Helvering v. F. & R. Lazarus and Co., 308 U.S. 252, 60 S. Ct. 209, 84 L. Ed. 226 (1939); Shaw Construction Co v. Commissioner of Internal Revenue, 9th Cir. 1963, 323 F. 2d 316."

Here, it cannot be denied that Worthen "continues to exercise all * * * [its] former control and stands in the same economic position as * * * [it] did prior to the transfer" of legal title to petitioner. As we have pointed out, Worthen's payments during the primary term of the lease were exactly equal to the amounts due under the New York Life mortgage. Moreover, the leaseback arrangement imposed virtually all risks, expenses, and obligations of ownership on Worthen. Thus, not only was Worthen responsible for repairs, maintenance, property taxes, insurance and operating expenses, but it was also required to hold petitioner harmless on all claims arising from the building, and

to comply, at its own expense, with all governmental regulations with respect to the building (I–A. 99–105, 213–214; Pltf. Ex. 19, II–A, 38–395, 404, 407–408). Under these circumstances, petitioner would neither receive nor expend any funds whatsoever in connection with its "ownership" of the building during the first 25 years of the arrangement.

To be sure, there are so-called "net" leases which require the tenant to bear all of the expenses of the property. Furthermore, a property may be so heavily mortgaged that its fair rental value could not exceed the principal and interest payable under the mortgage. Thus, these two facts, standing alone, would not require the conclusion that a sale and leaseback was a financing transaction. The court of appeals acknowledged as much in stating that "many of the features of the lease in this case have been held not to terminate tax ownership when viewed independently" (Pet. App. B 30a). But the court correctly observed (*ibid.*) that "[t]he vice of the present lease is that all of these features have been employed in the same transaction with the cumulative effect of depriving * * * [petitioner] of any significant ownership interest."

Lazarus teaches that the critical element in determining whether these arrangements are true sales or financing transactions is the option to repurchase. If, as in this case, the purported lessee has an option to repurchase the property at an amount that is significantly less than its fair market value, then the necessary inference is that the "rent" paid is not for the use of the property but is the amortization mechanism

for a loan on the security of the property.[23] For while the lessee may decline to exercise the option, the low exercise price makes it highly improbable that he will fail to do so, especially after amortizing the loan over the term of the "lease."

Here, as in *Lazarus,* Worthen had the option, at various times during and at the end of the 25-year term, to reacquire the property at prices that bore no relation to its fair market value unencumbered by the bargain terms of the lease renewal periods (see pp. 44–48, *infra*). Under the option, Worthen could repurchase the building by paying or assuming the unpaid balance of the mortgage and repaying petitioner's $500,000 plus interest. As a result, each payment of "rent," to the extent it was allocable to amortization of the mortgage, reduced the option price on a dollar-for dollar basis. Thus, like any mortgagor, Worthen did not permanently relinquish its ownership of the building but could recover it at any time by paying or assuming the principal balance of the mortgage and the additional $500,000 of financing provided by petitioner. And like any mortgagee, petitioner could expect no more from the transaction than to recover its $500,-000 advance, plus interest.[24]

Moreover, the rentals over the extended term of the lease likewise demonstrate that the arrangement was

[23] The deduction for business rent is limited to property "to which the taxpayer has not taken or is not taking title or in which he has no equity." Section 162(a)(3) of the Code.

[24] At the end of the primary term, the final option price was $2,145,935, which was equal to petitioner's $500,000 plus interest compounded at six percent for 25 years (Pltf. Ex. 13, II–A. 350).

a financing transaction and not a sale. During the 25th year of the lease, when the New York Life mortgage was still outstanding, the net rentals payable by Worthen were $613,154 ($613,156 less $2 ground rent payable to Worthen). But if Worthen extended the lease, its net rent for each of the next five years was reduced by more than two-thirds to $200,000 ($300,-000 less $100,000 ground rent). During the two succeeding five-year terms, the net rent was $150,000 and $100,000, respectively. Finally, during the next 25 years of the extended term, the annual net rent was even further reduced to $50,000.

Petitioner made no showing that these reductions in rent were geared to the projected fair rental value of the property. Indeed, the testimony was precisely to the contrary. Worthen's president characterized the extended term rentals as a "very, very cheap price" (I–A. 168). Petitioner's president, Frank Lyon, acknowledged that these rents were "low" (I–A. 261) and its real estate appraiser agreed that they were "favorable to the bank" (I–A. 251). Thus, even if Worthen did not exercise the option to repurchase, the bargain rentals during the extended 40-year term would permit it to deprive petitioner of its right to a fair payment for the use and occupancy of his property.

Under these circumstances, petitioner cannot be deemed to "own" the property when its rights in it are so severely diminished.[25] Moreover, the rents dur-

[25] In support of its contention that it, rather than Worthen, owns the building, petitioner argues (Br. 40–41) that it will be

ing the extended term were calculated to permit Worthen to repay petitioner's $500,000 investment plus interest. As the court of appeals correctly noted, at the time of the expiration of the primary term, "the present value of the future net rentals for the next 40 years, discounted at six percent, would approximate * * * [petitioner's] original half-million dollar investment plus the compounded interest accrued to that date" (Pet. App. B 26a).[26]

In sum, whether Worthen exercised the option to repurchase or to renew the lease, petitioner would

---

free to deal with the building at a reduced ground rent during the last ten years of the ground lease when the extended building lease will have expired. But such hypothetical rights that may arise after 65 years in the year 2034 are hardly relevant in determining which party is entitled to depreciation and mortgage interest deductions during the first 25 years of the arrangement. While petitioner speculates that it will receive $2.9 million during this final ten-year period (Br. 40), its own expert witness testified that after 25 or 30 years many such buildings would be functionally obsolete (I–A. 241). Likewise, the *amicus curiae* National Realty Committee agrees that (Br. 9–10) "it is highly probable that the economic life of the building will be exhausted during the ground lease term."

[26] While the final option price was $2,145,935, C. V. Barnes, petitioner's real estate appraiser, testified that the present value of the rentals over the 40-year extended term, discounted at six percent, would be less than that figure (I–A. 251). The computation yields $1,816,550. See C.R.C., *Standard Mathematical Tables, Interest Tables—Present Value of Annuity*; American Institute of Real Estate Appraisers, *The Appraisal of Real Estate*, pp. 427–467 (6th ed.). But as the court of appeals noted (Pet. App. B 27a), petitioner would have the opportunity to make up the difference during the final ten years of the ground lease. During that period, the ground rent was reduced to $10,000 per year and petitioner could negotiate a new rental with Worthen or another tenant.

receive no more and no less than its original $500,000 plus a fixed rate of interest. Under these circumstances, petitioner had no economic stake in the building, because it had "no return related to ownership risk" (Pet. App. B 28a); it simply loaned $500,000 to Worthen, to be repaid after 25 or 65 years, at Worthen's election.

Finally, the provisions of the lease relating to condemnation or destruction of the property were likewise geared to petitioner's $500,000 investment. In those events, New York Life would first be paid the mortgage balance, petitioner's recovery would be limited to its $500,000 advance plus six percent interest, and Worthen would receive the excess (Pltf. Ex. 19, II-A. 408-417). Thus, there was no possibility that petitioner would ever benefit from any appreciation in the value of the building. As the court of appeals correctly concluded, "the benefits, risks, and burdens which * * * [petitioner] has incurred with respect to the building are simply too insubstantial to establish a claim to the status of owner for tax purposes" (Pet. App. B 29a).[27]

3. The decisions of the lower courts support the foregoing analysis. In determining whether the sale-and-leaseback arrangements are true sales or financing

---

[27] Since Worthen retained title to the underlying land, it was assured, in any event, of recovering absolute possession of the property on the expiration of the ground lease ten years after the end of the extended term of the building lease. In this respect, the law of Arkansas is in accord with the general common law rule that, unless the parties agree otherwise, improvements to real estate made by the lessee return to the owner of the land on the

transactions, the courts have emphasized the relationship of the lessee's option to repurchase to the property's fair market value, as well as the other factors present in this case. As the court put it in *Commissioner* v. *H. F. Neighbors R. Co.*, 81 F. 2d 173, 175 C.A. 6), a pre-*Lazarus* decision, "The more common criteria which indicate a borrowing and lending rather than purchase and sale, are inadequacy of consideration, provisions for redemption or reconveyance, continued possession and management of the property by the transferer, payment by him of taxes and assessments, and his receipt and use of the rents and prof-

expiration of the lease. See *Williams* v. *Kirby School Dist. No. 32*, 207 Ark. 458, 181 S.W. 2d 488, 490. While the parties may express a different understanding, they did not do so here.

Petitioner attempts to fill the gap by arguing (Br. 42) that "there is no equitable reason" why the common law rule should apply because Worthen "sold" the building to petitioner. But this contention assumes the very question in the case, *i.e.*, whether the arrangement was a sale or a financing transaction. Indeed, given the understanding of the parties that petitioner's return would be limited to six percent on its $500,000 and Worthen's amortization of the mortgage (Pltf. Ex. 13, II–A. 349–351), the "equities" strongly favor Worthen's absolute recovery of the building at the expiration of the ground lease. Thus, *Stirman* v. *Cravens*, 33 Ark. 376 (Sup. Ct.), upon which petitioner relies (Br. 42–43), is distinguishable. The "somewhat anomalous" (*id.* at 384) facts that prompted the court in that case to make an equitable division of the sales proceeds of property between land and improvements are absent here. The court of appeals therefore correctly characterized petitioner's claim to some form of equitable adjustment 75 years in the future as "dubious" (Pet. App. B 27a n. 6). At all events, it is hard to see how such a claim is relevant in considering whether petitioner is entitled to depreciation and mortgage interest deductions during the first 25 years of the arrangement.

its of the property." Accord: *Leeds and Lippincott Co.* v. *United States,* 276 F. 2d 927 (C.A. 3), affirming an unreported decision of September 1, 1959 (D. N.J.);[28] *Starr's Estate* v. *Commissioner,* 274 F. 2d 294 (C.A. 9); *Oesterreich* v. *Commissioner,* 226 F. 2d 798, 802–803 (C.A. 9); *Breece Veneer & Panel Co.* v. *Commissioner,* 232 F. 2d 319, 322–323 (C.A. 7); *American Realty Trust* v. *United States,* 498 F. 2d 1194, 1199 (C.A. 4); *Frito-Lay, Inc.* v. *United States,* 209 F. Supp. 886 (N.D. Ga.); *Frenzel* v. *Commissioner,* 1963 P–H Memo TC par. 63,276, decided October 7, 1963. See also *Estate of Franklin* v. *Commissioner,* 544 F. 2d 1045 (C.A. 9).

The commentators likewise agree that where the option price is not geared to the fair market value of the property the lessee in a sale and leaseback arrangement is considered to be the owner for tax purposes. Thus, in discussing the tax consequences of a sale and leaseback, Professor William L. Cary has written that where the option to repurchase is at a nominal price, "[t]he obvious danger lurking in such an option is that the sale will not be treated [by the Commissioner] as such but rather that the whole transaction will in effect be regarded as a loan." Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations,* 62 Harv. L. Rev. 1, 23 (1948).

[28] We are lodging with the Court ten copies of the district court's unreported decision in *Leeds and Lippincott Co.*, and are serving it upon counsel for the petitioner.

Similarly, in a more recent appraisal that focuses on this case and concludes that it was correctly decided, the authors reaffirm that the option to purchase "appears to have been the basis for most decisions." Rosenberg and Weinstein, *Sale-leasebacks: An analysis of these transactions after the* Lyon *decision,* 45 Journal of Taxation 146, 150 (September 1976). In describing the case law, they state that "Where the option price was relatively substantial in the context of the case, ownership by the lessor was sustained. Where the option price was nominal, the lessee has been considered the owner for tax purposes (footnotes omitted) (*id.* at 150)." In their view, "[t]his result is consistent with the realities of the business bargain" (*ibid.*). Finally, in describing the decision in this case, the authors conclude that "where a fixed price, as in *Frank Lyon Company,* is designed merely to provide the lessor with a predetermined fixed return, the substantive bargain is more akin to the relationship between a debtor and creditor than between a lessor and lessee" (*id.* at 149).

C. THE BARGAIN TERMS OF THE LEASE RENEWAL ARRANGEMENT DEMONSTRATE THAT IT IS A FINANCING TRANSACTION AND NOT A TRUE SALE

1. Petitioner does not claim "to controvert the long established principle of tax law that substance is to prevail over form" (Br. 49). Moreover, it does not dispute the relevance of the fact that an option price is less than the fair market value of the property in these sale-and-leaseback arrangements. To the contrary, petitioner acknowledges that in such transac-

tions (Br. 19–20) "[t]he option prices may be so low that it is inevitable that the option will be exercised and obvious that the parties intended that it would be * * *." However, it argues (Br. 28) that "the option prices and rentals were reasonable estimates of market values * * * and the district court found that they were the reasonable estimates of market price * * *." In support of this characterization, petitioner cites the testimony of C. V. Barnes, a Little Rock realtor.

But there is nothing in the record to support the district court's conclusion that the option purchase prices were reasonably geared to fair market value. Worthen's president acknowledged that, apart from the fact that Worthen had such favorable extension privileges under the lease, the building "would be a good buy" (I–A. 11) at the $2.1 million option price at the end of the primary term. Moreover, Barnes explained that his testimony that the option price was a reasonable attempt to approximate fair market value (I–A. 241) was based on the sharply reduced rental income that the building would yield during the extended terms of the lease (I–A. 251). As the court of appeals correctly observed (Pet. App. B 26a), "The parties took no account of likely appreciation in the value of the building nor inflationary factors, the latter an almost constant factor in economics for the past 40 years, nor otherwise provided for purchase at a future appraised valuation of the building."

Moreover petitioner chooses to focus only upon Barnes' testimony with respect to the rentals during the primary 25-year term (I–A. 236, 240). It is, however, the extended term rentals that are crucial to this case because they are, in the context of this transaction, the functional equivalent of an unreasonable option-to-purchase price. With respect to the extended term rentals, Barnes conceded that they were "favorable to the bank" (I–A. 251) and Worthen's president described them as a "very, very cheap price" (I–A. 168).

"Figures speak and when they do, Courts listen." *United States* v. *Jackson Oldsmobile, Inc.*, 371 F. 2d 808, 809 (C.A. 5) (Brown, *J.*, concurring). Here, the figures eloquently confirm the witnesses' uniform characterization of the renewal rentals. While Worthen was obligated to pay approximately $600,000 per year in building rent during the primary term 1968–1994), the extended term net rentals were cut to $200,000 per year for the first five years, $150,000 for the second five-year term, $100,000 for the third five-year term, and $50,000 per year for the next 25 years until the year 2035.[29]

Because of these reduced rents, there would be no need for Worthen to exercise its repurchase option in

[29] The reductions in rent during the extended term were accomplished by increases in the ground rent payable by petitioner to Worthen. While the ground rent was $50 for the initial 25-year term, it increased to $100,000 per year for the first five-year extended term, and in $50,000 increments for the next two five-year terms, and to $250,000 for the next 25 years. See p. 12, *supra*.

1994 for $2.1 million, since it could have continued to control the building at a "very, very cheap price" without reacquiring title to it. The testimony cited by petitioner that Worthen was unlikely to exercise its repurchase option (Br. 20–21 nn. 12, 13) is therefore irrelevant because that testimony was given in the context of the axailability of the favorable option to renew the lease.[30] As Barnes testified, "I don't think in 1994 it would be economic for Worthen Bank to exercise the option to purchase, *because* I think the rental terms on the building thereafter are favorable to the bank" (I–A. 251) (emphasis supplied). Put another way, when faced with the alternatives of paying $2.1 million in 1994 to repurchase the property or $1.8 mil-

[30] In computing the deficiency in petitioner's tax liability for 1969, the revenue agent assumed that Worthen would exercise its option to repurchase the building at the end of the 11th year, when petitioner would cease to have any net tax deductions from the arrangement (see Pltf. Ex. 36, II–A. 595). Accordingly, the agent included in petitioner's 1969 income the amount of interest ($2,298.15) allocable to the one month in that year that the arrangement was in effect (see Pltf. Ex. 52, II–A. 689–690). The district court rejected this determination on the ground that Worthen's exercise of the option was "highly improbable" (Pet. App. A 11a). The testimony as to the improbability of Worthen's exercise of the option was based upon the availability of the option to renew the lease. Thus, that testimony does not affect our basic submission that petitioner had no significant ownership interest in the building (see text above). However, the record does support the district court's holding with respect to the includability of the aliquot portion of interest income. Accordingly, we did not appeal that aspect of the case to the court of appeals. Since the correctness of the district court's decision as to the interest income is not before this Court, there is no occasion for us to address petitioner's arguments (Br. 34–37) concerning this issue.

lion in deductible rent over the next 40 years (the present value of the rents over the extended term), simple economics would dictate that Worthen elect the latter alternative. Thus, in any event, Worthen will possess and control the building throughout its economic life.

It is, moreover, no answer for petitioner to argue (Br. 31) that Worthen would not extend the lease because it was "likely that Worthen would need another new building by the end of the 25-year period." If, as the record demonstrates, the extended term rentals are "very, very cheap," Worthen would be free to exercise the purchase option and sell the building, sell its leasehold interest or sublet the building to other tenants at a profit. The fact that Worthen may not occupy any part of the building itself after 25 years has nothing to do with the question whether it would extend the lease with petitioner. The opportunity for profit presented by the bargain renewal rentals refutes petitioner's assertion (Br. 33) that Worthen "loses nothing by walking away at the end of 25 years * * *."

2. The relevance of such an option to renew the lease is confirmed by the commentators and the case law. As early as 1948, before the lower courts began to apply the *Lazarus* standard to these arrangements, Professor Cary warned that "eminent counsel have been conservative and have advised a reasonably short-term lease, with very limited or no renewable rights"

Cary, *supra*, 62 Harv. L. Rev. at 26.[21] The subsequent lower court decisions proved the correctness of Professor Cary's observation.

A more recent commentary summarizes the case law as follows: "A second factor heavily relied upon by prior cases was the renewal rentals. Nominal renewal rentals taint a transaction. However, renewal rentals that are fixed in advance and are lower than initial term rental are acceptable if reasonable in the context of the transaction. Only unreasonably low renewal rentals are suspect because such rentals will effectively deprive the lessor of his ownership right to a fair payment for the use and occupancy of his property [footnotes omitted]." Rosenberg and Weinstein, *supra*, 45 Journal of Taxation at 150. Accord: *Starr's Estate* v. *Commissioner*, *supra*, 274 F. 2d at 296; *Mt. Mansfield Television, Inc.* v. *United States*, 239 F. Supp. 539, 541–542, 544 (D. Vt.), affirmed, 342 F. 2d 994 (C.A. 2), certiorari denied, 382 U.S. 818. *Frenzel* v. *Commissioner*, *supra*; Rev. Proc. 75–21, Sec. 4(2), 1975–1 Cum. Bull. 715, 716. Cf. *Midler Court Realty, Inc.* v. *Commissioner*, 521 F. 2d 767, 770 (C.A. 3).

Finally, our analysis of the option to renew the lease is supported by the standards recently promulgated by the accounting profession's Financial Accounting Standards Board. See FASB Statement of Financial Accounting Standards No. 13, Accounting for

---

[21] *Lazarus* itself involved a 99-year lease that was renewable for a like period (see 32 B.T.A. at 634).

Leases 1–14 (November 1976).[32] Pursuant to those standards, a lease is classified as a "capital lease" and must be recorded as an asset on the books of the lessee if one or more of the following criteria are present: (1) the lease transfers ownership of the property to the lessee by the end of the lease term; (2) the lease contains a bargain purchase option; (3) the lease term (*including bargain renewal options*) is equal to 75 percent or more of the estimated period during which the property is expected to be economically usable by one or more users, with normal repairs; or (4) the present value at the beginning of the term of the lease payments equals or exceeds 90 percent of the excess of the fair value of the leased property to the lessor at the inception of the term over any related investment credit retained by the lessor (see *id.* at pp. 2–5, 9–10).

If the arrangement qualifies under any one of the foregoing criteria, it will qualify as a capital lease. But as we shall now show, the transaction meets at least the third and fourth categories if not the second category, of the Financial Accounting Standards Board. The arrangement here may not meet the first criterion because it does not, by its terms, automatically transfer title of the building back to Worthen at the end of the lease term. But even assuming *arguendo* that there is no bargain purchase option within the meaning of the second category, the ar-

[32] See also Gant, *Illusion in Lease Financing*, 37 Harv. Bus. Rev. (No. 2) 121 (1959); Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 Real Estate Law J. 664 (1974).

rangement would still be classified as a "capital lease" under the third and fourth criteria outlined above.

With respect to the third criterion, the 65-year lease term (25 year primary term and 40 year bargain rental term) is surely equal to 75 percent or more of the estimated economic life of the building. If this criterion were inapplicable, the building would have to have an economic life of more than 86⅔ years (65÷0.75) and it strains credulity to presume that the Worthen Building would be functional after 86 years without major renovation. Indeed, petitioner itself (Br. 31) cites the testimony of C. V. Barnes that after about 25 or 30 years, such buildings "had to have some extensive money spent on them to cure a problem, and certain functional problems you couldn't cure" (1–A. 241).

Under the fourth accounting criterion, it is equally apparent that the present value of the lease payments at the beginning of the term equals the principal sum of the New York Life mortgage of $7.1 million. If the value of the property at the inception of the term equaled its $7.6 million cost, the present value of the rentals during the primary term ($7.1 million) is more than 90 percent of the value of the property. It is 93 percent of the $7.6 million, without taking into account the value of the renewal rentals ($1.8 million—see p. 40 n. 26, *supra*).

In sum, even under the standards of the traditionally conservative accounting profession, which is normally reluctant to attribute ownership of an "asset"

unless there are strong assurances that the purported "owner" has unfettered control and use of the property, the Worthen Bank would be regarded as having the significant ownership interest in the building under a capital lease and petitioner would be classified as a party to a "direct financing lease." [33] Thus, accepted methods of accounting would likewise regard Worthen as the owner of the building in accordance with the economic substance of the transaction.

D. SINCE PETITIONER IS NOT THE TRUE OWNER OF THE BUILDING, IT CANNOT CLAIM DEDUCTIONS FOR MORTGAGE INTEREST OR DEPRECIATION

The foregoing discussion demonstrates that the pertinent judicial and scholarly authorities support the court of appeals' decision that the arrangement between petitioner and Worthen was a financing transaction and did not give rise to a true sale of the building from Worthen to petitioner. To the contrary, under the analysis of *Lazarus* and its progeny in the lower courts, the transaction was a $500,000 non-recourse loan (on the security of the building) from petitioner to Worthen to be repaid in either 25 or 65 years, at the election of Worthen.

[33] From the standpoint of the lessor (petitioner), the Financial Accounting Standards Board rules (*supra*, at pp. 8, 10) provide that a lease will be classified as a sales-type lease (one that gives rise to manufacturer's profit) or a direct financing lease if it meets any one of the four criteria discussed above and (i) collectibility of the rent is reasonably predictable; and (ii) no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor. Here, both those latter conditions are met so that the lease would be classified as a direct financing lease.

1. *Mortgage interest.*—The court of appeals correctly held that petitioner cannot claim deductions for the interest paid on the New York Life mortgage. Petitioner's role was at best a conduit between Worthen and New York Life for transmission of the mortgage payments. However, petitioner's performance of this function does not give rise to an interest deduction."

It was Worthen that obtained the benefit of the amortization of the New York Life loan by reducing its option price on a dollar-for-dollar basis as the loan was amortized over its 25-year term. Moreover, like any mortgage debtor, Worthen guaranteed to New York Life that it would unconditionally make the "rental" payments (which exactly equaled the principal and interest) for the duration of the primary term and pledged its ownership of the land, parking facility, and easements as security for the New York Life loan. "Interest on indebtedness" within the mean-

[34] Petitioner argues (Br. 38–39) that the conduit analysis of the court of appeals is inconsistent with *Commissioner* v. *Brown*, 380 U.S. 563. There, the Court held that the transfer of the stock of a corporation to a tax-exempt charity followed by the charity's liquidation of the corporation and leaseback of the assets to a newly organized corporation owned by the transferor was a sale for tax purposes, despite the fact that the purchase price was to be paid out of the earnings of the corporation. But the ground of the decision in *Brown* was that there was an actual transfer of property for a fixed price upon payment of which "the Brown family would forever lose all rights to the income and properties of the company" (*id.* at 569). Here, however, Worthen did not transfer to petitioner "all rights" to the building; it only transferred bare legal title to secure the repayment of petitioner's $500,000 advance with interest.

ing of Section 163(a) of the Code "means compensation for the use or forbearance of money." *Deputy* v. *duPont,* 308 U.S. 488, 498. See also *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, 560. Since Worthen enjoyed the use of the funds produced by the New York Life loan, it is Worthen and not petitioner that is entitled to deduct the interest paid on that mortgage.

Petitioner's sole claim to the mortgage interest deduction is based upon the form of the transaction, *viz.,* that (Br. 25) it "was solely liable on full recourse loans."[35] But the taxpayer's execution of a deed in *Lazarus* did not require the conclusion that a sale had occurred. As the Court there stated, "In the field of

[35] Petitioner also argues (Br. 44) that the conduit analysis of the court of appeals is, at all events, inapplicable to the interest paid on the interim City Bank construction loan. But that issue is not before the Court since the court of appeals, in response to petitioner's petition for rehearing, modified its opinion to provide for a remand to the district court for further findings with respect to petitioner's claimed deductions for interest on the interim construction loan and for miscellaneous additional expenses in connection with these agreements (Pet. App. D 32a–33a).

Moreover, the agreements between the parties appear to refute petitioner's claim to interest deductions on the interim construction loan. The sales agreement provided that "interim interest on the construction loan" would be credited to the $7.6 million "purchase price" under that agreement (Pltf. Ex. 25, II–A. 514). Moreover, Worthen included the interim interest in the list of costs "it has paid" that it submitted to New York Life (Deft. Ex. 11, II–A. 701, 704) and its accountants certified that such interest was "incurred and paid" by Worthen (Deft. Ex. 12, II–A. 705, 706). Thus, it appears that Worthen and not petitioner bore the economic burden of the interest on the interim construction loan.

taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering* v. *F. & R. Lazarus & Co., supra,* 308 U.S. at 255. Here, too, petitioner's role as the formal obligor on the New York Life note must be viewed in the context of the entire arrangement.

As part of the set of interlocking documents, Worthen executed a separate agreement promising New York Life that it would not terminate the lease[36] for any reason as long as the mortgage remained outstanding (Pltf. Ex. 29, II–A. 582). This promise, together with Worthen's consent to petitioner's asignment of the building lease as security for the loan, locked Worthen into the arrangement. Petitioner's obligation on the note was thereby effectively shifted to Worthen as an unconditional obligation owed to New York Life.[37] Moreover, as we have pointed out, *supra,* pp. 18, 36, Worthen agreed to pay its "rentals" directly to New York Life (Pltf. Ex. 29, II–A. 582).

[36] New York Life required, as a condition to its loan, that the building lease be acceptable to it (Pltf. Ex. 17, II–A. 358–362).

[37] If Worthen defaults on its obligations to New York Life, petitioner would be required to step in and satisfy the conditions of the mortgage. But until that event occurs, there is no basis to petitioner's claim to the deductions for the mortgage interest that Worthen has in fact paid for the use of the funds provided by New York Life. In this context, petitioner was an accommodation party to a loan effectively made to Worthen. Cf. *Nelson* v. *Commissioner,* 281 F. 2d 1, 5–7 (C.A. 5); *United States Fidelity & Guaranty Co.* v. *Commissioner,* 40 B.T.A. 1010, 1017–1019.

Under these circumstances, it is something of an overstatement even to characterize petitioner's role as that of a conduit, because it does not appear even to have actually received or transmitted the mortgage payments. Thus, apart from its formal execution of the mortgage note, petitioner performed absolutely no function with respect to the mortgage payments. There is accordingly no basis to petitioner's claim to deduct mortgage interest on the New York Life loan.[38]

2. *Depreciation.*—Just as petitioner is not entitled to deduct interest on the mortgage obligation that was effectively shifted to Worthen, it cannot claim depreciation deductions on the building encumbered by that mortgage. As Mr. Justice Brandeis explained for a unanimous Court in *United States* v. *Ludey,* 274 U.S. 295, 300, "The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used." There is no doubt that the building subject to the arrangement at issue in this case is subject to wear and tear and is eligible for depreciation. The question, however, is which party to the transaction—Worthen or petitioner—can deduct that depreciation on its return.

[38] The Treasury Regulations support this analysis. See Treasury Regulations, Section 1.163–1(b) (26 C.F.R.), which provides that the "equitable owner" of property may deduct the interest paid on the mortgage even though he is not directly liable on the mortgage note itself.

Lazarus supports the decision of the court of appeals that Worthen and not petitioner is entitled to the depreciation deduction on the building. There, in considering the tax consequences of an essentially equivalent sale-and-leaseback transaction, the Court noted that the allowance for depreciation was intended to benefit the taxpayer that actually "bear[s] the burden of exhaustion of capital investment" (308 U.S. at 254), without regard to whether it holds legal title to the property. Here, Worthen stands on the same economic footing as the taxpayer in *Lazarus,* which purportedly sold and leased back its building. As we have shown, Worthen is effectively obligated to discharge the mortgage obligation on the building and will enjoy the benefits of the building over its entire economic life.[39] Under these circumstances, it is Worthen that made the economic investment in the building and thereby bore the burden of the exhaus-

[39] *World Publishing Co.* v. *Commissioner,* 299 F. 2d 614 (C.A. 8), upon which petitioner relies (Br. 22–23), is distinguishable. There, the taxpayer purchased property subject to a long-term lease, consisting of land and a building constructed by the lessee. The court held that the taxpayer could allocate a portion of the purchase price to the building and depreciate that amount over the remaining term of the lease. In the court's view, the taxpayer and the lessee each had "separate wasting investment[s]" meeting the statutory requirements for depreciation (299 F. 2d at 622). But cf. *M. DeMatteo Construction Co.* v. *United States,* 433 F. 2d 1263 (C.A. 1) (deduction denied where the term of the lease extended beyond the remaining useful life of the building). Here, however, only one wasting investment was made and, as we have shown, Worthen made that investment.

tion of capital investment in the building that is the prerequisite for the depreciation deduction.[40]

E. THE ARRANGEMENT IN THIS CASE WAS NOT THE PRODUCT OF ARMS LENGTH BARGAINING

In holding that the sale and leaseback in this case was a financing transaction and not a true sale, the court of appeals properly recognized that such transactions "are an accepted and useful means of controlling business property" and that its "opinion should not be read as a general condemnation of sale-leaseback arrangements" (Pet. App. B 30a). As Professor Cary observes, "[o]ne of the primary reasons presently given by companies for adopting the sale and leaseback is that they may thereby secure a larger aggregate amount of capital than through any other form of debt financing." Cary, *supra,* 62 Harv. L. Rev. at 5–6. Moreover, he points out that the arrangement enables a business to circumvent the legal restrictions

[40] Contrary to petitioner's further argument (Br. 27–30), the decreasing option purchase prices and the reduced rentals during the extended term do not show that petitioner bore the burden of the depreciation of the building. The decreasing option prices were geared to the ratable amortization of the mortgage. Indeed, from petitioner's standpoint, the option prices will steadily increase at a fixed rate of six per cent, compounded annually. Moreover, as we have shown (pp. 39–40, *supra*), the reduced rentals bore no relation to the declining value of the building but were likewise set to provide petitioner with a six per cent return on its $500,000 advance.

The only contingency under which petitioner would be entitled to depreciation deductions with respect to the building would be if Worthen declined to exercise the option either to purchase or to extend the lease. But even in that event, the only capital investment made by petitioner that would be subject to exhaustion would be its $500,000 outlay. Accordingly, its depreciations deduction would be limited to its $500,000 cost basis. See Section 167(g) of the Code.

imposed upon direct borrowing by bonds, term loan agreements, or preferred stock (*id.* at 14).

We do not dispute that the sale and leaseback in this case may have been prompted by the fact that banking regulations prevented Worthen from showing the building on its books as an asset (see pp. 4–5, *supra*). But this consideration did not dictate the particular details of the arrangement that provided petitioner with no "significant ownership interest" in the building (Pet. App. B 28a). The record shows that Worthen rejected other sale-and-leaseback proposals under which Worthen's repurchase option was not simply geared to a return of the outside investor's advance. (See p. 8 n. 7, *supra,* and p. 63 n. 43, *infra.*) Thus, the existence of a non-tax reason for entering into a sale and leaseback does not support petitioner's generalized assertions (Br. 15) that the "transaction should be taxed as it was structured by the parties" and that (Br. 21) the "tax laws should * * * take the transaction * * * as it finds it * * *."[41]

[41] Petitioner also complains (Br. 18) that the court of appeals "made it impossible for a future tax planner to structure such an arrangement with any confidence or security * * *." But the parties to such sale and leaseback arrangements may obtain an advance ruling from the Internal Revenue Service, which will appraise a proposed transaction in accordance with its published criteria. See Rev. Proc. 75–21, 1975–1 Cum. Bull. 715. See also Rev. Rul. 55–540, 1955–2 Cum. Bull. 39.

Moreover, parties to such arrangements can seek the advice of counsel. The record shows that Worthen sought legal advice as to the tax consequences of a sale and leaseback transaction with respect to the building and received comprehensive opinion letters setting forth the pertinent considerations under the *Lazarus* standard (Deft. Exs. 14, 15, II–R. 708–741). There is, however, nothing in the record that indicates whether petitioner received independent legal advice in connection with the transaction.

If such were the rule, the form of an arrangement would control its tax consequences as long as those consequences are in accord with the parties' expectations. But such a rule cannot be squared with the requirement of *Lazarus* that the economic substance of these sales and leasebacks must be examined on a case-by-case basis and that the formal nomenclature of the parties is not controlling for tax purposes. Indeed, petitioner's claim that the tax law must take its cue from the parties' understanding is refuted by this Court's statement in *Commissioner* v. *Duberstein*, *supra*, 363 U.S. at 286, that "* * * [i]t scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter." Thus, the fact that petitioner and Worthen hoped to shift the mortgage interest and depreciation deductions to petitioner does not require that the Commissioner honor that expectation when the objective economic substance of the transaction shows that petitioner is not the owner of the building.[42]

In support of its argument that "[t]he tax laws should * * * take the transaction between the parties

[42] Petitioner argues (Br. 44–46) that the Commissioner's determination that Worthen owns the building for tax purposes is inconsistent with *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394. There, this Court held that the Commissioner could not exercise his authority under Section 482 of the Code to allocate insurance commissions to the taxpayer when it was prohibited by federal banking law from earning such commissions. Petitioner urges that (Br. 45) "it would similarly be illegal for Worthen Bank to own the building here in question" and that the Commissioner's position "amounts to a denial that banking regulations have tax 'substance' " (*ibid.*).

as it finds it * * *" (Br. 21), petitioner characterizes the arrangement as the product of "[H]ard, arms-length negotiations" (Br. 28). As petitioner views the matter, the allegedly adverse interests of the parties are sufficient to protect the revenue from "a sale of tax benefits" (Br. 17).

The record, however, does not support petitioner's characterization of the negotiations. Indeed, quite the contrary is the case. As the trial testimony demonstrates, the sale-and-leaseback transaction originated

But the federal banking law did not make it "illegal" for Worthen to "own" the building. The applicable statutory provisions simply required Worthen to obtain the approval of the Board of Governors of the Federal Reserve System to invest more than the amount of its capital stock in bank premises. See 12 U.S.C. 371d. Since the federal and state banking authorities approved Worthen's participation in the arrangement (Pltf. Exs. 40, 44, II–A. 612, 622), the rule of *First Security Bank of Utah* is inapplicable. Thus, the court of appeals correctly observed that its opinion "in no way affects Worthen's relationship to the Worthen building, as recognized by federal and state banking regulations" (Pet. App. B 30a).

At all events, in giving their approval to the transaction, the banking authorities did not purport to consider whether it was a true sale or a financing transaction in accordance with the criteria this Court established in *Lazarus*. Indeed, the fact that both the federal and state bank authorities described the arrangement as a "plan of financing" (II–A. 612, 622) strongly suggests that they were well aware that Worthen was undertaking a long-term debt obligation and was not simply a conventional lessee.

Finally, *First Security Bank of Utah* turned on "the inequity of attributing to the Bank's taxable income that they have not received and may not lawfully receive" (394 U.S. at 405). But that consideration is inapplicable here. The Commissioner's denial of petitioner's claimed mortgage interest and depreciation deductions was based upon the facts that petitioner did not benefit from the New York Life loan and did not make an investment subject to capital exhaustion.

solely with Worthen and Worthen dictated all of its terms. Petitioner's role in the "negotiations" was entirely passive.

Worthen's president testified that petitioner had "nothing whatsoever to do" with determining the substantive provisions of the contract (I–A. 155). After incorporating the "best part" of each of the offers it had received, Worthen formulated a counterproposal (Pltf. Ex. 13, II–A. 349–351) which petitioner immediately accepted (I–A. 143–144). Petitioner did not seek to obtain any additional benefits for itself. Instead, upon accepting the Worthen's counterproposal, Frank Lyon wrote to Worthen's president as follows (Pltf. Ex. 14, II–A. 352):

> Dear Ed:
>
> We have reviewed your proposal submitted to us yesterday. Unequivocably, we would like to accept it.
>
> However, we do not feel that this proposal is the best for Worthen Bank, therefore, we accept your proposal with one major change. Your lease payments for the first five years will be reduced by $21,000 annually. On the enclosed sheet we have listed the points contained in your specification for easy comparison of our amended proposal with your proposal.
>
> Ed, as you know already, we want very much to be of service to Worthen Bank.
>
> Yours truly,
>
> FRANK LYON COMPANY,
> /s/ Frank Lyon,
> FRANK LYON,
> *Chairman of the Board.*

A letter in which the lessor offers to reduce the rent proposed by the lessee hardly shows hard, arms-length bargaining. To the contrary, it demonstrates that there was no bargaining, much less arms-length bargaining, between Worthen and petitioner with respect to the details of the arrangement. Worthen dictated all of the terms and insured its complete control over the property for its economic useful life.[43] Petitioner in turn expressed its willingness to accept whatever Worthen proposed, and even volunteered further concessions to its own financial detriment. (see I–A. 71).[44] The parties were therefore in no sense adverse within the accepted meaning of that term.[45] From petitioner's

---

[43] Thus, Worthen unilaterally chose the option purchase price and the bargain rentals during the extended term. In marked contrast, the Goldman, Sachs proposal called for a repurchase option based on fair market value (Pltf. Ex 9, II–A. 343). The Stephens proposal called for a fixed repurchase price at the end of the primary term substantially in excess of that provided for in the arrangement at issue. However, the record does not indicate how that price was computed.

[44] As we have pointed out (p. 10 n. 8, *supra*), petitioner's concession on the rent was unacceptable to New York Life, which insisted that the rent be equal to the principal and interest payments under the mortgage (I–A. 109). However, petitioner's $105,000 concession ($21,000 x 5) was reflected in increased interest charges on a loan from Worthen to petitioner (*ibid.*).

[45] *Commissioner* v. *Danielson*, 378 F. 2d 771 (C.A. 3), certiorari denied, 389 U.S. 858, and *Levinson* v. *Commissioner*, 45 T.C. 380, upon which petitioner relies (Br. 22), are therefore distinguishable. There, the courts held that the parties to a sales agreement of a going business cannot introduce parole evidence to contradict their written allocation of a portion of the purchase price to a covenant not to compete. In such a situation, the parties are bound by their allocation because their interests are adverse. The buyer can deduct the amount allocated to the covenant over its term and

(Continued)

standpoint, the prospect of $1.5 million of net tax savings from the depreciation deductions during the period 1969–1980 (Pltf. Ex. 36, II–A. 595) made it unnecessary for it to bargain over the details of the arrangement.

Finally, petitioner urges (Br. 17) that "there is no justification for scrambling the bargain between Lyon and Worthen" where "there is no differential in tax rate or any special tax circumstance affecting one of the parties." While there may be particular instances in which an audit of both parties to a sale-and-lease-

(Continued)
the seller must include those amounts in ordinary income. Thus, every dollar added to the covenant not to compete produces a permanent tax benefit for the buyer and an equal tax detriment to the seller.

Here, on the other hand, the parties are not in directly adverse positions. If the form of the arrangement were honored, the seller-lessee (Worthen) would be able to shift the depreciation deductions to the buyer-lessor (petitioner) but would receive the benefit of rental deductions equal to the sum of the mortgage interest and amortization. Thus, Worthen would be able to write off the building over a 25-year useful life, rather than the 45-year period suggested by the Service as an appropriate useful life for office buildings. See Rev. Proc. 72–10, 1972–1 Cum. Bull. 721, 731. As Professor Cary indicates, this is a major tax advantage to the seller-lessee in this type of sale and leaseback. See Cary, *supra*, pp. 18–19. If an accelerated method of depreciation is used, the net effect of the arrangement is a temporary "trade-off" by the lessee of the large depreciation deductions it would have had available in the early years in exchange for larger deductions in the latter years as the normally nondeductible mortgage amortization increases (see Pltf. Ex. 36, II–A. 595–596). At all events, *Danielson* and *Levinson* held only that the parties are bound by their allocation and not that the Commissioner would be required to accept an unrealistic allocation. Cf. *Copperhead Coal Co.* v. *Commissioner*, 272 F. 2d 45, 48 (C.A. 6); *F. & D. Rentals, Inc.* v. *Commissioner*, 44 T.C. 335, 345.

back transaction does not result in the collection of additional revenues for a given year, that fact is wholly coincidental and cannot serve as a reasoned ground for permitting the tax consequences of these long-term arrangements to follow the formal labels adopted by the parties. As we have noted (p. 64 n. 45, *supra*), these arrangements can be mutually advantageous to both parties. Moreover, we are advised by the Internal Revenue Service that in the large majority of these cases involving sale and leasebacks or equipment leasing, the parties are not in the same tax posture. Usually, the lessee has losses and cannot benefit from the deductions attributable to the ownership of property so it "sells" them to a high-bracket taxpayer such as petitioner in exchange for financing. In other cases, the lessee is a corporation whose effective tax rate is less than that of a wealthy individual. Thus, if the transaction is taxed in accordance with its actual economic substance, these differences in the tax brackets or taxable status of the parties will result in the collection of additional revenue.

II

THE COURT OF APPEALS CORRECTLY HELD THAT THE FEDERAL TAX CONSEQUENCES OF A SALE AND LEASEBACK PRESENT A QUESTION OF LAW

The court of appeals properly observed that "[i]n this case the allocation of interests between parties is spelled out in undisputed written documents" (Pet. App. B 24a). The court thereupon analyzed these doc-

uments and the undisputed testimony to determine whether in economic substance "the transaction between the taxpayer and the * * * bank, in written form a transfer of ownership with a leaseback, was actually a loan secured by the property involved." *Helvering* v. *F. & R. Lazarus Co., supra,* 308 U.S. at 255. After making the required analysis, the court concluded that "the benefits, risks, and burdens which * * * [petitioner] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes" (Pet. App. B 29a).

Petitioner contends (Br. 46–54) that the court of appeals improperly reversed the district court's decision in its favor because the "clearly erroneous" standard of Fed. R. Civ. P. 52(a) protected the district court's "detailed factual findings" (Br. 46) that the parties intended the transaction to be a sale and leaseback with option to repurchase.

But the court of appeals did not dispute the district court's finding as to the intent of the parties. Instead, the court of appeals held that where, as here, the allocation of interests between parties is spelled out in undisputed written documents, the characterization of the transaction for tax purposes "is the law obligation of the court as distinguished from its fact finding duties." *United States* v. *Winthrop,* 417 F. 2d 905, 910 (C.A. 5); *American National Bank of Austin* v. *United States,* 421 F. 2d 442, 451 (C.A. 5), certiorari denied,

400 U.S. 819. Thus, the court of appeals did not make new findings as to the intent of the parties in derogation of Rule 52(a). Rather, it held that, as a matter of law, subjective intent "is simply immaterial to the characterization of the transaction for tax purposes" (Pet. App. B 24a).[46]

In this respect, the decision below is in accord with the other courts of appeals that have held that the question whether such agreements are true sales or financing transactions is one of law. *American National Bank of Austin* v. *United States,* 421 F. 2d 442, 451 (C.A. 5), certiorari denied, 400 U.S. 819; *Union Planters National Bank of Memphis* v. *United States,* 426 F. 2d 115, 117–118 (C.A. 6), certiorari denied, 400 U.S. 827; *Estate of Franklin* v. *Commissioner,* 544 F. 2d 1045, 1047 n. 3 (C.A. 9); *American Realty Trust* v. *United States, supra,* 498 F. 2d at 1198. See also *ABKCO Industries, Inc.* v. *Commissioner,* 482 F. 2d 150, 155 (C.A. 3). Thus, it is the objective economic substance of the arrangement and not the parties' sub-

[46] Petitioner also argues (Br. 46–47) that the court of appeals failed to give appropriate deference to the district court's findings (Pet. App. A 5a–6a) that the rent to be paid during the term of the lease and the option prices were reasonable. But as we have pointed out in Point I.C., *supra*, pp. 45–46, there is nothing in the record to support the district court's conclusion that the option prices were geared to fair market value. Moreover, the district court's findings with respect to the rents were based solely on the rents during the primary term and did not consider the bargain rents during the extended term. These bargain rents made it unnecessary for Worthen to exercise the option to purchase. By extending the lease, Worthen could exercise complete dominion over the building for its entire economic life.

jective intent that is controlling in these cases. "If the parties enter into a transaction which they honestly believe to be a lease but which in actuality has all the elements of a contract of sale, it is a contract of sale and not a lease no matter what they call it nor how they treat it on their books." *Oesterreich* v. *Commissioner*, *supra*, 226 F. 2d at 801–802."

American Realty Trust v. *United States*, *supra*, upon which petitioner relies (Br. 51–53) is not to the contrary. There, as here, the court of appeals examined the transaction in the light of the controlling legal standard established by this Court's decision in *Helvering* v. *F. & R. Lazarus & Co.*, *supra*. However, it concluded that the details of the arrangement were "sufficiently distinguishable from those in *Lazarus*" (498 F. 2d at 1199). It therefore held that there was sufficient evidence to support a jury verdict that the purchaser-lessor in a sale-and-leaseback transaction had an ownership interest in the property so as to be entitled to include the rental payments in its income and deduct the mortgage interest and depreciation, and to qualify as a real estate investment trust."

"Cf. *Benton* v. *Commissioner*, 197 F. 2d 745, 752 (C.A. 5). There, the court stated that "[i]f the parties in good faith actually intended to enter into a lease contract, then the taxpayer, up until the time that he exercised his option to purchase, acquired no title to or equity in the property." However, the Fifth Circuit has subsequently indicated that "the nomenclature used and the intent of the taxpayer cannot alone control the tax consequences of a particular series of transactions." *United States* v. *Henderson*, 375 F. 2d 36, 40. See also *Carlton* v. *United States*, 385 F. 2d 238, 243.

"Unlike this case, the rental payments in *American Realty Trust* were not equal to the principal and interest payments on the underlying mortgage so as to establish the conduit role of the lessor that exists here. Indeed, the agreement in that case provided that the rent was to be reduced by only 50 percent of the reduction in the mortgage payments. Moreover, the agreement in *American Realty Trust* personally bound the seller-lessee to pay the rent only for the first six years of the 21-year lease and permitted him to assign the lease thereafter (see 498 F. 2d at 1195). Here, however, Worthen had an absolute obligation to make the rental payments and it agreed that it would not cancel the lease as long as the mortgage was outstanding. There was accordingly no realistic possibility that petitioner would bear the risks of the rental market for the building.

Furthermore, the lessor in *American Realty Trust* was entitled to 60 percent of any condemnation award over the sum of the mortgage balance, the lessor's cash advance, and the value of the tenants' leasehold estate (*ibid.*). Here, on the other hand, petitioner would receive no part of any condemnation award to the extent it exceeded the mortgage balance and its $500,000 advance.

Finally, unlike this case where Worthen could acquire title to the property either by exercising the repurchase option or by means of its reversionary interest, the lessee in *American Realty Trust* could only acquire title through the repurchase option. There, the court held that there was testimony tending to show that the lessee exercised his repurchase option "because of the sudden availability of 'wrap-around' financing, not because there was any 'economic compulsion' to repurchase inherent in the deal" (498 F. 2d at 1199). Given these distinguishing characteristics, the court of appeals in this case correctly concluded that "[t]he arrangement * * * [in *American Realty Trust*] was not nearly so thin and transparent as the present transaction" (Pet. App. B 29a). Accord: Rosenberg and Weinstein, *supra*, 45 Journal of Taxation at 151.

But in so holding, the court did not rule that the question of sale versus financing transaction was properly put before the jury as a question of fact. To the contrary, in considering the government's second argument that the documents established that the transaction was actually a loan as a matter of law, the court agreed that "[t]he characterization of the ques-

tion in issue as 'legal,' not 'factual,' admittedly has a basis in decisional law." It further observed that this Court in *Lazarus* "suggested that the determination of the *bona fides* of a sale-and-lease-back transaction involves, ultimately, a legal conclusion, albeit one grounded in underlying findings of fact [footnote omitted]" (498 F. 2d at 1198).

In sum, the variations inherent in sale-and-lease-back arrangements require that they be examined on a case-by-case basis under the economic substance standard of *Lazarus*. Results will necessarily differ in accordance with the details of the transaction. But the ultimate characterization of these arrangements for tax purposes presents a question of law freely reviewable by an appellate court. The court of appeals properly performed that function here and concluded on the undisputed facts of this case that "[t]he overall nature of this transaction is closely akin to that in [*Lazarus*]" Pet App. B 28a).

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.
M. CARR FERGUSON,
Assistant Attorney General.
STUART A. SMITH,
Assistant to the Solicitor General.
GARY R. ALLEN,
JOHN A. DUDECK, JR.,
Attorneys.

JULY 1977.

U.S. GOVERNMENT PRINTING OFFICE: 1977